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FEDERAL FISCAL AND MONETARY POLICY
AS COUNTER-CYCCLICAL WEAPONS

RICHARD G. MURPHY
JOHN E. WILDMAN

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FEDERAL FISCAL AND MONETARY POLICY
AS COUNTER-CYCLICAL WEAPONS

by

Richard G. Murphy

Lieutenant Commander, United States Navy

and

John E. Wildman

Lieutenant, United States Navy

Submitted in partial fulfillment of
the requirements for the degree of

MASTER OF SCIENCE
IN
MANAGEMENT

United States Naval Postgraduate School
Monterey, California

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ABSTRACT

During the period since World War II the U. S. economy has experienced four temporary recessions. Although the postwar recessions have been brief and mild by standards of the 1930's, interruptions of any magnitude in our national economic growth are cause for concern. All four of these recessions brought -- with varying degrees of timeliness and effectiveness -- attempts by the federal government to take corrective action through the use of fiscal and monetary policy. Particular antirecession fiscal and monetary actions can be better or worse with respect to effectiveness, timing, efficiency and compatibility with other goals, and some of the policies pursued in the past have been worse rather than better.

This paper investigates the character and uses of fiscal and monetary policy and the related public debt creation as federal antirecessionary weapons. Chapter I constitutes an introduction to the paper. Fiscal policy, monetary policy and the public debt are discussed in Chapters II, III and IV respectively. In Chapters V and VI the recessions of 1953-54 and 1957-58 are examined in detail with emphasis on an evaluation of the timeliness and effectiveness of fiscal and monetary actions. Chapter VII offers some conclusions concerning the possible choices of fiscal and monetary actions for future recessions and conclusions concerning the avoidance of recession and maintenance of progressive economic growth.

Chapters I, II, V and VII were prepared by Lieutenant John E. Wildman, and Chapters III, IV and VI were prepared by Lieutenant Commander Richard G. Murphy.

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CHAPTER I

INTRODUCTION

Modern economics undertakes to explain, among other things, how it is that nations are alternately afflicted with the ups and downs of business activity. In the pre-Industrial Revolution days, before the development of our present technology, there were often periodic famines. Statistical data showed that the number of marriages moved inversely with the price of bread -- when bread became dear, marriages had to be postponed. Millions of people died as a result of floods, droughts, plague, locust invasions or other easily recognized natural catastrophes. The causes of such disasters were well known, but nobody could do much about them.¹

Today the situation is just the opposite. We now know how to produce a fair abundance of goods, but we are subject to periodic depressions of obscure causation. Bread is cheap in depression, and marriages today follow job opportunities rather than the cost of food. Famine resulting from crop failure in one part of the world can now be relieved by shipments from elsewhere. And in an apparently topsy turvy world people go hungry in modern economic slumps, not because we can produce too little, but seemingly because we can produce too much².

Members of our senior generations bear scares of the Great Depression of the 1930's, a period that has been equated with World War II in the amount of economic resources wasted. An onlooker from an earlier

¹Paul A. Samuelson, Economics-An Introductory Analysis (New York: McGraw-Hill Book Company, Inc., 1958), p. 4.

²Ibid.

century would have thought that everybody had lost their senses. Sheep were driven into rivers to drown while families did without meat. Because we had efficient new factories, we did without production. With too many skilled and willing hands unemployment prevailed. People tried to save and hoard money with the result that they got poorer and poorer.

The history of the business cycle including the Great Depression has prompted economists to intensify efforts to understand and analyze fluctuations in our national income. Although economics is by no means an exact science a considerable body of knowledge has been developed, contributing to a neoclassical synthesis which may be partially stated as follows: "by means of appropriately reinforcing monetary and fiscal policies, our mixed-enterprise system can avoid the excesses of boom and slump and can look forward to healthy, progressive growth".³

However, during the period since World War II our economy has experienced four temporary recessions. Although the post-war recessions have been brief and mild by standards of the 1930's, interruptions of any magnitude in our national economic growth are cause for concern. All four of these recessions brought -- with varying degrees of timeliness and effectiveness--attempts by the federal government to take corrective action through the use of fiscal and monetary policy. Particular anti-recession fiscal and monetary actions can be better or worse with respect to effectiveness, timing, efficiency and compatibility with other goals, and some of the policies pursued in the past have been worse rather than better.

It is the purpose, therefore of this paper to investigate the character and uses of fiscal and monetary policy and the related public debt creation as federal antirecessionary weapons. Fiscal policy, monetary

³Ibid., p. 360.

policy and public debt will be discussed in Chapters II, III, and IV respectively. Furthermore, in Chapters V and VI the recessions of 1953-54 and 1957-58 will be examined in detail with emphasis on an evaluation of the timeliness and effectiveness of fiscal and monetary actions. Finally Chapter VII will offer some conclusions concerning the possible choices of fiscal and monetary actions for future recession or even better to avoid recession and maintain progressive economic stability and growth.

CHAPTER II

FISCAL POLICY

INTRODUCTION

It is the purpose of this chapter to analyze the character and uses of fiscal policy. The definition given to fiscal policy here is the policy of the government with respect to the total amount of its own expenditures, the total amount of its taxes, and the relations between these totals, which is the surplus or deficit.¹ By a positive fiscal policy is meant the process of shaping public taxation and public expenditure so as (1) to help dampen down the swings of the business cycle, and (2) to contribute toward the maintenance of a progressive, high-employment economy free from excessive inflation or deflation.²

Federal fiscal policy has proven to be a powerful weapon, particularly in the war years -- so powerful in fact that some feel that men and governments should not be allowed to play with it, and that it would be better if fiscal policy were never used. However, it simply doesn't make sense to allow the business cycle to push us into recession when we have tools to dampen it. Therefore, the choice is to attempt to lead fiscal policy along economically sound rather than destructive channels.

DEFLATIONARY AND INFLATIONARY GAPS

Given a deflationary gap situation in which private consumption and investment spending were too weak to provide adequate employment, action would be called for to put into effect stabilizing policies necessary to dampen the recessionary tendency and to bring the economy

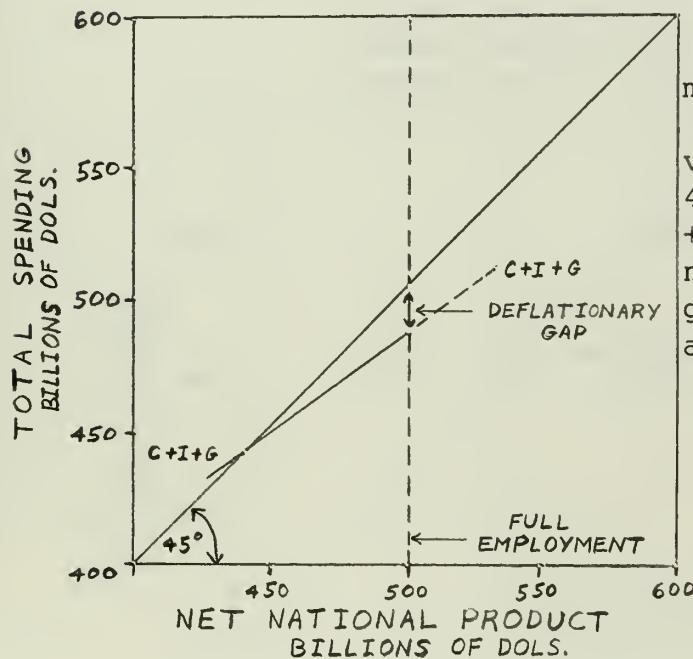
¹ Committee For Economic Development, Fiscal and Monetary Policy for High Employment (New York; January 1962), p. 13.

² Samuelson, op.cit., p. 344.

back to full employment. The Federal Reserve would use expansionary monetary policy to try to stimulate private investment. To the extent that its efforts were not fully successful a deflationary gap would still exist. Timely action would then be required by the government to introduce tax and/or federal expenditure policies designed to help the economy again achieve stable full employment. In this case a decrease in tax or an increase in federal expenditures would be called for. This subject will be discussed in more detail in a later section.

FIGURE 1
DEFLATIONARY GAP

When total spending (consumption + investment + government spending) is less than NNP at full employment. . .



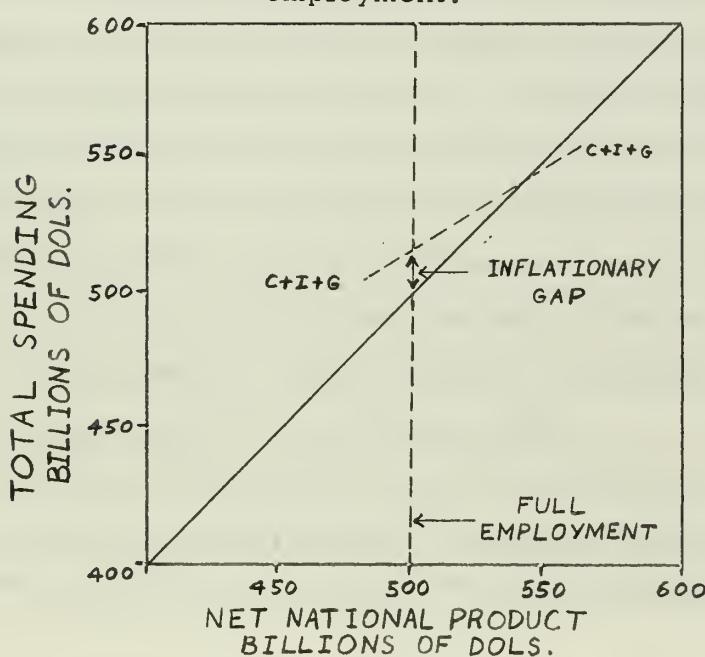
The deflationary gap is measured at full employment NNP level. It is the vertical distance between the 45 degree line and the C+I+G schedule at full employment. Such a deflationary gap will depress income in a multiplied way.

Also, given a situation in which private investment and consumption decisions were threatening the economy with an inflationary gap, in which prices are rising and employers are competing for nonexistent workers, the Federal Reserve would initiate contractionary credit programs aimed to dampen the inflationary tendency. Furthermore, to the extent that the inflationary gap persisted, governmental action would be called for to increase taxes and/or decrease federal expenditures to restore the economy to stability and to remove the inflationary gap.

FIGURE 2

INFLATIONARY GAP

When prices are being bid up and total spending is greater than NNP at full employment.



The inflationary gap is the vertical distance between the 45 degree line and the $C + I + G$ schedule at full employment.

To summarize, it can be said that "fiscal policies dealing with taxes and public expenditure, in cooperation with stabilizing monetary policies, have for their goal a high-employment economy -- but one without price inflation. The fiscal and monetary authorities lean against the prevailing economic winds, thereby helping provide a favorable economic environment within which the dynamic forces of private initiative can have the widest opportunity for achievement."³

THE BUILT-IN STABILIZERS

It is important to note that our fiscal system is organized in such a manner that all stabilization requirements do not necessitate discretionary action on the part of the authorities. We have built-in stabilizers that automatically counteract destabilizing influences on the economy. Built-in fiscal stabilizers, as an antirecessionary tool, might be defined as those federal receipts and expenditures which, in response to contractions in the economy, operate in the direction of increasing the federal deficit or decreasing the surplus without the need for policy decision or action. The major stabilizers fitting this definition are the individual and corporate income taxes, excise taxes, employment taxes and unemployment benefit payments. Other built-in stabilizers that might be mentioned are various governmental aid programs such as aid to farmers and even personal and corporate savings to the extent that they are spent on consumption and investment and therefore produce a cushioning effect.

To illustrate the effect of built-in stabilizers it is easy to see that as soon as income begins to decrease the federal tax receipts will begin to fall off and that unemployment compensation will begin

³ Ibid., p. 345.

to go up. In other words the built-in fiscal stabilizers help support the economy in recession mainly by reducing the rate at which an initial decrease in demand and in earned income before tax tends to have a multiplier effect on the economy by inducing further declines in expenditures for personal consumption. For example, because a drop in income reduces tax liability (on a progressive basis), after-tax incomes drop by less than if there were no decline in tax liability. It seems intuitively clear from this that private expenditures based on these after-tax incomes also drop by less than if there were no decline in tax liability. Likewise, the rise in unemployment compensation in recession cushions the decline in consumption by keeping the drop in disposable income less than the drop in income earned. In addition to these effects on consumption, the built-in stabilizers also cushion potential decreases in business investment. This is done indirectly to the extent that inventory of fixed investment is influenced by private consumption expenditures which, as a result of the stabilizers, are more stable than they would be otherwise. This effect results directly to the extent that investment is influenced by current after-tax business receipts.

It is interesting to note that the elements of the federal budget which have automatic stabilizing effects with respect to fluctuations in the economy, did not come into existence for this purpose. To the contrary, built-in stabilizer effects are an incidental benefit of legislation enacted for other purposes.⁴

GOVERNMENT SPENDING AND THE "MULTIPLIER"

The major weapons of discretionary fiscal policy are (1) changing

⁴

Wilfred Lewis, Jr., Federal Fiscal Policy in the Postwar Recessions (Washington: The Brookings Institution, 1962), pp. 26-27.

tax rates and (2) changing government expenditure programs. Holding tax constant, a change in federal expenditures will act on the economy in a multiplied manner in the same way that a change in private investment acts on the economy. An increase in government expenditure will increase national income by an amount greater than the increase itself. This amplifier effect of government expenditure on income is called the "multiplier" effect. The term "multiplier" is used for the numerical coefficient showing how great an increase in income results from each increase in government spending. The term is used most commonly in connection with the private investment segment of national income, but it applies also to government expenditures.

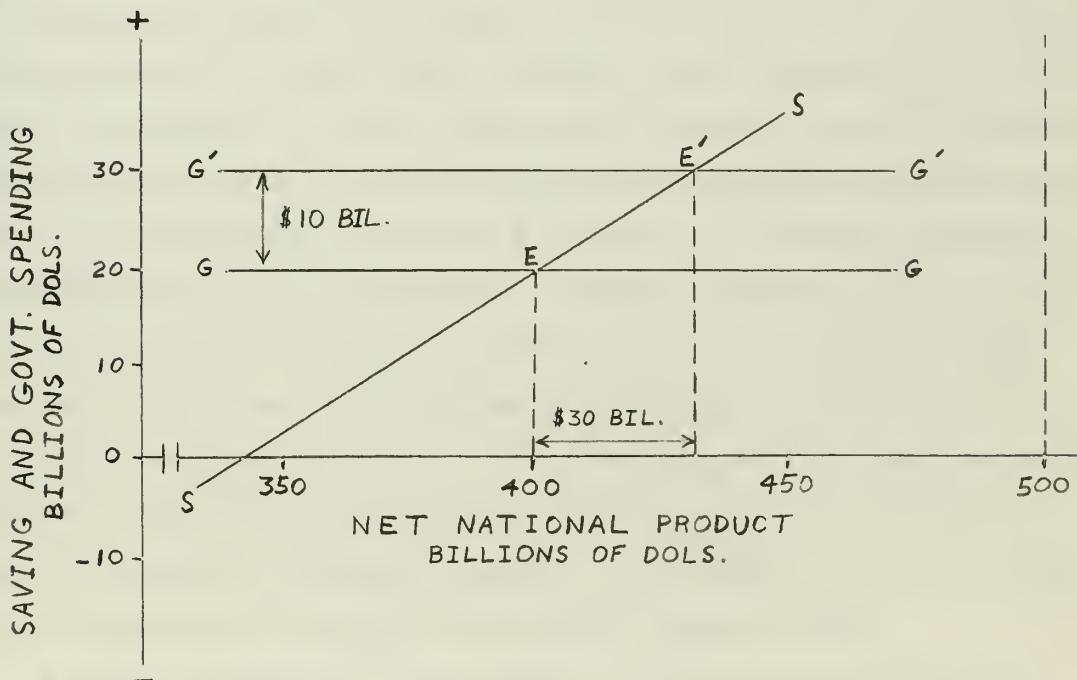
The multiplier effect is the result of a whole chain of secondary consumption spending set in motion by primary expenditures of the federal government for, say, polaris missiles. Those providing labor, materials and services to build the missile will receive payments amounting to the cost of the missile which for purposes of example costs, say, \$1000. These people will in turn spend part of this on new consumption goods. The amount they spend will depend on their marginal propensity to consume (MPC). If their MPC is $2/3$ they will spend \$666.67 on new consumption goods. The producers of these goods will then have an extra income of \$666.67, part of which they will in turn spend. If their MPC is also $2/3$, they will pass on \$444.44 in new purchasing. And so the chain of spending goes on to an aggregate of \$3000 or 3 times the primary expenditure if everyone in the chain has an MPC of $2/3$. The multiplier is numerically equal to the reciprocal of one minus MPC or simply the reciprocal of the marginal propensity to save (MPS), which is one minus MPC. In the example cited the multiplier is three. The general multiplier formula in the case of government expenditure is:

$$\begin{aligned}\text{Change in income} &= \frac{1}{1-\text{MPC}} \quad \text{X change in government expenditure} \\ &= \frac{1}{\text{MPS}} \quad \text{X change in government expenditure}\end{aligned}$$

To demonstrate further the effect of the multiplier a graphic explanation is provided below.

FIGURE 3

Given a MPS of $1/3$, which is the slope of the savings schedule, an increase in government spending of \$10 billion will shift the government spending schedule from equilibrium at E to a new equilibrium at E'. This results in an increase in NNP of \$30 billion.



TAX REDUCTIONS

A tax change is the other major discretionary fiscal weapon of the federal government. A reduction in the tax rate will mean that people will have higher real disposable incomes which in turn means that consumption spending will increase. And thus the national income will be increased. Part of each dollar increase in disposable income, however, is saved, and therefore, the dollar rise in initial consumption spending will not be quite as great as the decrease in taxes. For this reason a tax change does not act quite as powerfully on the economy as does a change in government expenditure.

In the mid 1930's when the government was wrestling with the Great Depression the tendency was to initiate work on public investment programs for the unemployed. These were often hastily devised, inefficient and trumped-up projects, but this was an attempt to use government spending as a lever on the economy. They apparently did not consider tax reduction -- in fact, they tried to raise tax rates! Since that time there have been two wars during which government spending soared, and it has subsequently stayed at a high level. Nowadays, however, when stabilizing action is required considerable emphasis is placed on tax-rate changes. One reason for this is that taxes are much larger than they used to be, and the government would never find itself with no more taxes to reduce rates on. Furthermore, with the large annual federal budgets that have existed in recent years it is politically difficult to increase government spending. And finally, it is safe to say that cutting taxes is simply a more popular public notion.

A serious drawback of tax cutting as an antirecessionary tool is the problem of timing. To be effective as antirecessionary tools, fiscal actions must be timely. This is currently a serious drawback of tax-cutting due to the fact that to change the tax rates Congressional

legislative action is required, and this is usually a very time consuming process. The proper moment for action has in all likelihood passed before appropriate legislation is enacted.

This is not, however, such a serious drawback on the spending program as a fiscal tool. The President of course cannot spend more than Congress appropriates, however, he does have considerable latitude on where and just when during a given year funds will be spent. He can therefore shift government projects into those areas of the country that are depressed and time the implementation of projects to the most advantage.

The important thing is that the constraint on cutting taxes confronts the government only with the alternatives of trying to raise expenditures or doing nothing. A solution to the problem is to make it possible for tax cuts to be effected rapidly. There is little doubt that governmental action will be taken in a serious recession. Therefore, the question raised by proposals to make tax reductions move available for use is not whether strong action should be taken. Rather, the question is whether the possibility of action should be limited to increasing government expenditures. As long as timely tax cuts are made impossible by political and institutional obstacles, action against a serious recession will most likely consist of larger spending. To limit the choice of alternatives in this manner seems unnecessary and unadvisable. To overcome this limitation one possibility that has been advocated is to authorize the President to propose temporary tax reductions (or increases), within limits as to duration and character specified by previous legislation, to take effect unless a concurrent resolution of disapproval is adopted by Congress within 60 days. In this connection there may be questions concerning the distribution of power between the Executive and the Legislative branches of the government, since under this

recommendation inaction or favorable action by one House would permit the President's proposal to go into effect, whereas positive action of disapproval by both Houses would be needed to prevent it. The advocates of the proposal, however, are not interested in tipping the balance of power between the President and Congress but are concerned with the government's ability to obtain a prompt decision to effect a tax cut when needed.⁵

⁵ Committee For Economic Development, Fiscal and Monetary Policy for High Employment (New York: January, 1962), pp. 32-34

CHAPTER III

MONETARY POLICY

Monetary policy, in a broad sense, concerns itself with all the measures that can be undertaken by the government to effect the expenditure or use of money by the public. Since this is such an all encompassing definition and includes the fiscal policies of the government as well, this chapter will describe monetary policy from a much narrower view. It will be concerned with the more traditional definition of monetary policy, that of controlling the economy's supply of money and credit by actions of the Federal Reserve Board. Monetary policy in this stricter sense, therefore, focuses on the objectives, the tools, and the processes of regulation of the supply of money and credit.¹

Monetary policy cannot and should not be separated from fiscal policy but rather should be looked at as the fine control, the vernier, that is utilized to combat inflationary/deflationary trends. Fiscal policy alone cannot properly combat these trends because, by itself, it is entirely too blunt; thus monetary policy complements it quite well.

Monetary policy was discarded by the government as a useful tool in the years following the Great Depression, but since 1951 has been relied on more and more as a major instrument for achieving the economic goals of the United States. As a people, we insist upon more rapid economic growth at a more even rate, and upon relatively more stable

¹Neil H. Jacoby, "Contemporary Monetary Issues, " United States Monetary Policy, Neil H. Jacoby, editor (New York: The American Assembly, Columbia University, 1958), p. 2.

prices, than was true at an earlier time. Thus monetary policy has become a subject of wide-spread public interest.²

PURPOSE

What then is the real purpose of monetary policy? Simply stated, it is to maintain full employment and full production, without inflation, in a free economy, or phrased differently it functions to foster a financial climate favorable to forces of economic growth while maintaining relatively stable prices. In our present economy enforcing these objectives often causes conflicts and, when given the choice between price stability and other objectives, monetary officials tend to give priority to price stability. Their rationale is that price stability promotes employment and growth in the long run. They believe that the sacrifice of price stability in the short run will lead to unemployment and low rate of economic growth in the long run.³ The incompatibility of these objectives has been clearly shown by the high unemployment figures in the so-called "good times" of the past decade.

Economic activity under modern private enterprise proceeds at an uneven rate which appears somewhat like a sine wave with an upward trend. When spending by the public, in relation to offerings of goods, is resulting in inflationary demand pressures in markets generally, monetary management has the task of restraining the expansion of bank credit and

² Ibid., p. 5.

³ James B. Ludke, The American Financial System (Boston: Allyn and Bacon, Inc., 1961), pp. 618-619.

money balances. When deflationary trends are evident, the task becomes that of encouraging expansion of bank credit and money balances. The fact that monetary policy cannot do this perfectly in no way detracts from its value, as a dynamic private enterprise economy needs undulation and adaptation to maintain its dynamism.⁴

The manner in which the Federal Reserve Board functions to control spending is described by Samuelson as follows (assume inflationary trend): To put on the monetary brakes the first step is to cut down on bank reserves. Assuming a 20 per cent reserve requirement, each dollar contraction in bank reserves forces a 5:1 contraction in total demand deposits. The contraction in total money makes credit generally "tight", which means both dearer and less available. With credit expensive and hard to get, private and public investment will tend to fall. Finally the pressure on credit and on investment spending will, through the downward shift in the I & G (investment plus government spending) schedule, have a downward effect on income and jobs.⁵

THE FED'S WEAPONS

The Federal Reserve Board relies on three interrelated instruments to regulate the reserve base of the commercial bank system. They are: open market operations, discount operations and changes in reserve requirements. These three instruments are utilized in a complementary fashion to change the supply of reserves and their cost to member banks.

⁴Ralph A. Young, "Tools and Processes of Monetary Policy," United States Monetary Policy, Neil H. Jacoby, editor (New York: The American Assembly, Columbia University, 1958), p. 13.

⁵Paul A. Samuelson, Economics (New York: McGraw-Hill Book Company, Inc., 1953), p. 314.

In addition to these general weapons, the Board has a special purpose instrument which is designed to prevent the excessive use of credit in the stock market. This tool is called the "margin requirement." Under special circumstances, such as national emergencies or exceptionally strong inflationary pressures, the aforementioned instruments have been supplemented by two other selective items -- the regulation of consumer credit and the regulation of real estate credit.

Open market operations consist of purchases or sales of government securities in the open market. Regardless of who may sell the securities purchased or who may buy the securities sold by the Federal Reserve, these transactions have a direct impact on the volume of member bank reserves. Through a chain of events, the Federal Reserve's purchases of government securities creates bank deposits as the sellers receive payment; this increases the amount of money available for lending thus forcing interest rates down. Conversely, when the Federal Reserve sells securities, deposits drop as the buyers pay for the securities, and interest rates tend to rise. The distinctive aspect of open market operations is that they are undertaken at the initiative of the Federal Reserve and, therefore, are an active reflection of the prevailing monetary policy. These open market operations are considered to be the most important stabilizing weapon used by the Federal Reserve.⁶

The twelve Federal Reserve Banks provide banking facilities for the member banks of the entire system. One of the traditionally provided services is that of making loans. These loans are usually in the form of

⁶Young, op. cit., p. 18.

advances on government securities and are commonly called "discounts". The interest rate charged by the Federal Reserve Bank is termed the discount rate, and it is regulated by the Board in a manner designed to combat inflationary and deflationary trends.

Raising the discount rate makes the money market tight and discourages loans, while lowering the rate has the opposite effect. When discounts are dropping the Board is helping bank reserves contract and reducing the economy's credit base, and conversely, when discounts are growing the member banks reserves are increasing and thus providing a larger credit base. The overall effectiveness of discount operations has never been conclusively determined although past performance suggests that it has more usefulness as a credit control in a normal or boomtime economy; while in a protracted depression it tends to be of little significance.⁷

One major drawback to this device is that the Federal Reserve Banks must play a passive role in that, although they can change the discount rates, they can't set the amount of discounts at any predetermined figure.

The third major tool of the Federal Reserve Board, changing reserve requirements, is the most powerful of all. Action to change the level of reserve requirements does not affect the amount of member bank reserve balances, but it does affect the amount of deposits and, therefore, of loans and investments that member banks can legally maintain on the basis of a given amount of reserves. Thus, according to the level of reserve

⁷ David H. McKinley, "The Discount Rate and Rediscount Policy," The Federal Reserve System, Herbert V. Prochnow, editor (New York: Harper and Brothers, 1960), p. 107.

percentage requirements in effect, a given amount of reserves can be made to do more or less bank credit and monetary work.

Two things happen when the required reserve percentages are changed. First, there is an immediate change in the liquid asset or secondary reserve position of member banks and second, there is a change in the rate of multiple expansion of deposits of the entire banking system. Thus, if the requirements are raised, the banks that have no excess reserves must find additional reserve funds by selling liquid assets in the market or by borrowing from other banks or from the Reserve Banks.

Since changes to reserve requirement levels become effective on some one selected date, an abrupt change in economic conditions is often the result. If the reserve requirements were raised the banks would have to act as described above until the new reserve requirements were met. This change would result in high interest rates, unfavorable credit, cuts in investments and reductions in national income and employment.⁸ It is clear indeed why this powerful weapon is seldom used.

The Federal Reserve Board also has the power to regulate stock market credit. This control takes the form of setting "margin requirements." They consist of the percentage of the value of stocks which a buyer is expected to supply from his own resources. For example, if the margin is 60 per cent, a bank or broker is permitted to lend the buyer no more than 40 per cent of the value of the stocks given as collateral. The regulation of stock market credit by the margin require-

⁸ Samuelson, op. cit., p. 323.

ment, though bearing directly on the lender, puts restraint on the borrower and thus dampens demand. The purposes of the margin requirement controls are to minimize the danger of excessive use of credit in financing stock market speculation, and to prevent the recurrence of speculative stock market booms based on credit financing, such as culminated in the price collapse of 1929 and the subsequent severe credit liquidation.⁹

The Board has, in the past, had the power to control installment and mortgage terms. With these controls they were able to control the amount of down payment required on cars, furniture and houses. They also could shorten the span of mortgages. These controls proved to be very unpopular even though quite powerful and were allowed to lapse after the Korean War.

UTILIZING THE WEAPONS

The basic tools of the Federal Reserve do not maximize their real effectiveness unless they are properly coordinated to meet varying situations. Open market operations, the most flexible and often used instrument, are the principal means of coping with short-term forces influencing member bank reserves. Discount operations, while they play some part in cushioning seasonal pressures on individual banks in areas subject to open market operations in dealing with cyclical swings in credit demand and money balances.¹⁰

Open market operations is the major weapon employed to vary the bank reserves in order to meet the economy's need for growth.

⁹ Young, op. cit., p. 30.

¹⁰ Ibid., pp. 32-33.

However, in times of economic recession, changes of reserve requirements are sometimes used in order to gain whatever stimulative effect that monetary expansion may provide. Reserve requirement levels may also be varied in special situations where large changes in the volume of reserves, such as result from sizable international movements of gold, need to be offset or cushioned.¹¹ The margin requirement functions as a supplement to the bank reserve instruments.

The main cyclical work of monetary management is carried out by complementary reliance on open market and discount operations. In a growing economy they work together to regulate the rate of expansion of member bank deposits and assets. In a boom period they retard the rate of expansion whereas in periods of recession they increase the expansion rate. Situations that require monetary action that induce an actual contraction in these strategic quantities seldom arise.

The impact of these monetary weapons is transmitted to the economy at large via the commercial banking system. Their immediate effect is to influence the availability and cost of credit at the commercial banks. After a short lag, reactions from the initial impulse pervade the economy, affecting not only borrowers and lenders but in some degree the spending and saving decisions of all households and business enterprises that participate in the financial process.

A graphic view of the Federal Reserve's structure in relation to its several instruments of monetary action is shown in figure 4.

¹¹ Ibid., p. 33.

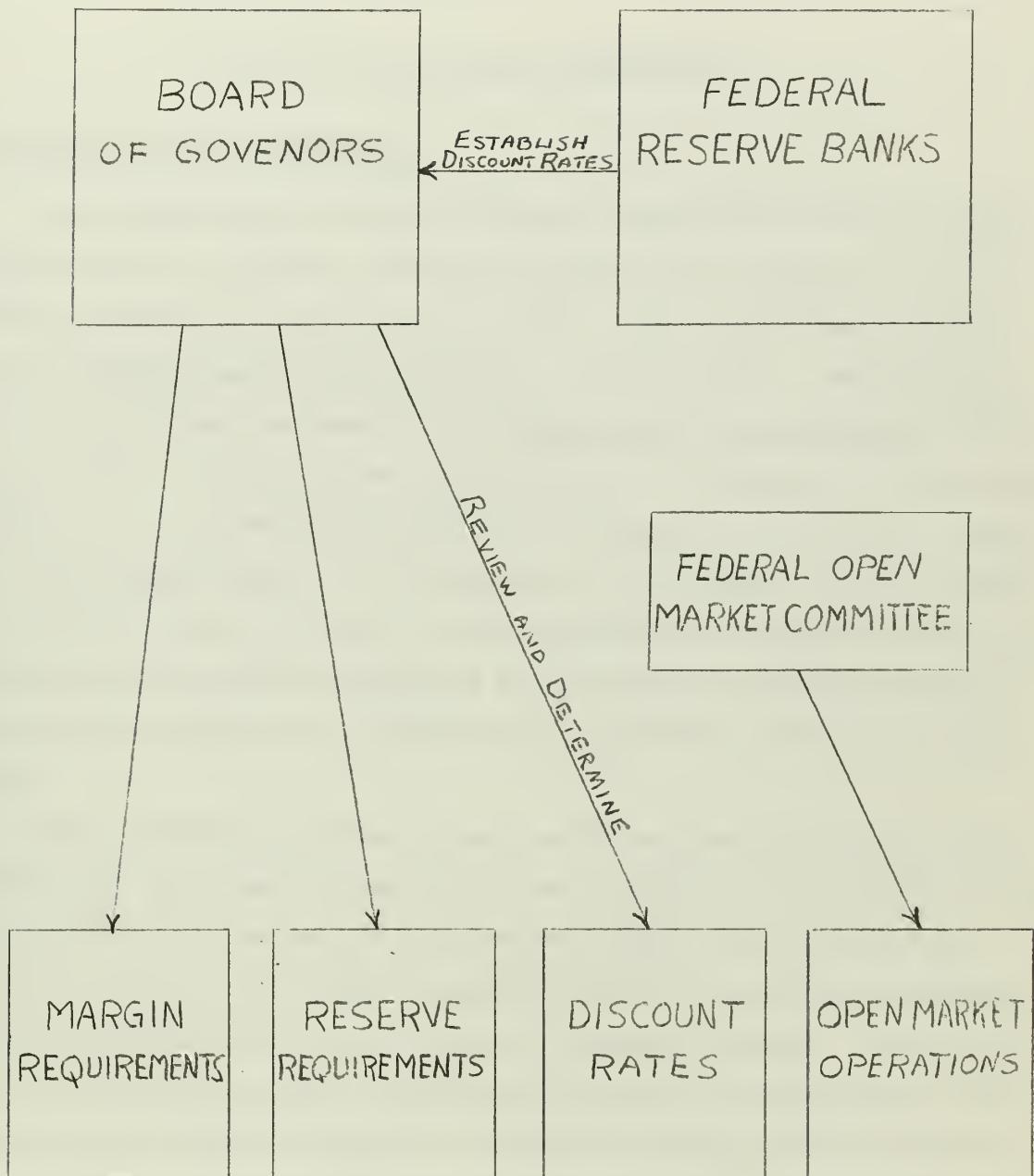


FIGURE 4

FEDERAL RESERVE ORGANIZATION FOR POLICY MAKING

CHAPTER IV

FALLACY OF THE BALANCED BUDGET

BALANCED BUDGET ATTITUDES

"We should make it the first principle of economic and fiscal policy in these times to maintain a balanced budget, and to finance the cost of national defense on a pay-as-we-go basis." Thus spoke Harry Truman in the Economic Report of the President, in January 1951. Dwight Eisenhower echoed these sentiments in his State of the Union Message in 1953 when he said, "The first order of business is the elimination of the annual deficit A balanced budget is an essential first measure in checking further depreciation in the buying power of the dollar". Why, in this age when the goals and tools of Keynesianism are so widely accepted, do we have this remarkable persistence in balanced governmental budgets?¹ Whatever the reasons are, they're sure to be flavored with political overtones.

This conservative attitude is built on the economic propositions that deficits may encourage irresponsibility and contribute to the growth of the public sector and that deficits may require a higher level of future tax rates. In addition many people apparently think of the national budget in the same manner in which they think of a household budget. Although the first two factors have some validity the third has none. What then is so sacred about a balanced budget? Is it bound to have a neutral effect on the economy, or will it enable the economy to grow? The fact of the matter

¹ Jesse Burkhead, "The Balanced Budget," Readings in Fiscal Policy, Arthur Smithies and J. Keith Butters, editors (Homewood, Illinois: Richard D. Irwin, Inc., 1955), p. 1.

is that a rising balanced budget exerts a net expansionary effect on the economy. (see Appendix I)

A balanced budget can be neutral in its effect on the economy, and it can, as well, be highly expansive and cause inflation, or it can be highly restrictive and cause depression. The budget that shows a surplus, although often regarded as being restrictive to the national economy, may in fact be inflationary. Conversely, a deficit budget, commonly thought to cause the economy to expand, can in fact be restrictive. It is necessary to examine the nature of expenditures and taxes before drawing any conclusion as to the effect of any budget on the economy.²

EXPANSIVE EFFECTS OF FEDERAL EXPENDITURE

In order to measure the effects of federal expenditures on the economy, it is necessary to know who receives the money, and how likely they are to spend it. If it is received by people who will save most of it, it is much less expansive than if it is received by people who will spend most of it. Distinction between government transfer payments and government income-producing payments must be made. The former represents merely a transfer of funds from the government to individuals and does not necessarily involve any employment or income creation. Income-producing payments, on the other hand, represent the purchase of goods or services and thus result in employment and income.

Government expenditures that directly result in the production of income such as public works and national defense expenditures are expenditures that release income funds; expenditures that result merely in making loanable funds available, via augmenting the supply of capital funds through various federal loaning activities, are expenditures that release capital funds.

² Harold M. Somers, Public Finance and National Income (Philadelphia: Blakiston, 1949), pp. 485-527.

The latter funds, if invested, will ultimately produce income, as will transfer payments, if and when they are spent.

RESTRICTIVE EFFECTS OF TAXATION

Taxation involves an absorption of both capital and income funds by the government. Sales tax and income taxes on low income groups absorb income funds, whereas taxes that impinge on savings, absorb capital funds. When income funds are absorbed, the consumer's expenditures and thus the national income are directly affected. Absorption of capital funds indirectly affects the national income as it tends to make the terms for borrowing for private enterprise less attractive.

RESTRICTIVE EFFECTS OF BORROWING

At first glance borrowing looks like a matter of absorption of capital funds by the government. However, if you consider the use the funds may have been put to, had they not been loaned to the government, it appears that income funds may have been absorbed as well. This is particularly true in the case of war bond programs and compulsory savings plans. Thus, it becomes apparent that government borrowing absorbs both capital and income funds.

EXPANSIVE EFFECTS OF DEBT REPAYMENT

The repayment of the debt also involves both capital and income funds. Some individuals utilize the funds they receive from bond redemptions for purchase of securities. For others, these funds represent the culmination of a savings program, particularly in the case of war bonds, and the funds are used for consumer spending, thus the latter usage is far more expansive than the former.

Using this dissection of the various budgetary factors, we can now see that a deficit budget, per se, often gives a misleading picture

of the government's contribution to the community's income funds. Thus the net effect of income fund release or absorption is an appropriate measure of the government's direct contribution to the nation's purchasing power.

It now follows that the net government release of income funds, rather than the deficit, is the appropriate over-all indicator of the direct expansive impact of budgetary policy. Since it is possible to have a net government release of income funds when the budget is balanced, it is possible to have an expansive effect on consumption, and thus national income, when the budget is balanced. For example, if expenditures are \$100-billion, made up of \$75-billion release of income funds and \$25-billion release of capital funds, and if tax revenues are \$100-billion, made up of \$70-billion absorption of income funds and \$30-billion absorption of capital funds, the net government release of income funds is \$5-billion. At the same time, the indirect restrictive impact is potentially \$5-billion in the form of a net absorption of capital funds. Whether this indirect restrictive influence is actually felt depends on the state of the banking system and the general availability of capital. In any case there is a direct expansive impact of \$5-billion even though the budget is balanced.³

Similar expansive and contractive effects can be determined by comparing the net results of the government's actions on income and capital funds utilizing both deficit and surplus budgets. In either case it is never the mere fact that a budget is deficit or surplus that determines the expansive or contractive force of a particular budget. It is the nature of the funds absorbed and released that determines whether or not a particular budget is expansive or contractive.

³ Harold M. Somers, Federal Expenditure and Economic Stability: The Fallacy of the Balanced Budget, unpublished report submitted to the Joint Economic Committee of the Congress of the United States, Oct., 1957.

By the way of a conclusion the following statement made by Evsey D. Domar seems appropriate.

When post-war fiscal policy is discussed, the public debt and its burden loom in the eyes of many economists and laymen as the greatest obstacle to all good things on earth. The remedy suggested is always the reduction of the absolute size of the debt or at least the prevention of its further growth. If all the people and organizations who work and study, write articles and make speeches, worry and spend sleepless nights -- all because of fear of the debt -- could forget about it for a while and spend even half their efforts trying to find ways of achieving a growing national income, their contribution to the benefit and welfare of humanity -- and to the solution of the debt problem -- would be far greater.⁴

⁴ Evsey D. Domar, "The Burden of the Debt and the National Income," Readings in Fiscal Policy, Arthur Smithies and J. Keith Butters, editors (Homewood, Illinois: Richard D. Irwin, Inc.), p. 500.

CHAPTER V

THE RECESSION OF 1953-1954

BACKGROUND

The recession of 1953-54 began with a downturn in the Gross National Product in July 1953. The peak to trough decline of \$10 billion is graphically illustrated in Figure 5. The large cutback in federal government expenditures associated with the end of the Korean War is believed to have been the major cause of the recession. Defense expenditures declined from an annual rate of \$53 billion in the 2nd quarter of 1953 to \$41.9 billion in the 3rd quarter of 1954.¹ A substantial decline in defense orders had begun in 1952 prior to the Eisenhower administration taking office. These reductions continued through the first six months of 1953, and with the signing of the Korean armistice in July, defense expenditures began an even more rapid decline.

President Eisenhower, upon assuming office in January 1953, inherited a budget prepared by the outgoing Truman administration. That was the budget for Fiscal Year 1954, which was to start six months later, and it included increased expenditures of \$4 billion and a sizable deficit. The incoming administration appeared to be much more concerned than its predecessors about the prospects of inflation. It is therefore interesting to note that during the early months of the new Eisenhower administration, the President was primarily concerned with the possible inflationary tendencies of the Truman budget for Fiscal Year 1954. Accordingly, President Eisenhower's efforts in those early months were largely directed toward revising the Truman budget downward, thus decreasing government

¹ Harold G. Vatter, The U. S. Economy in the 1950's -- An Economic History (New York: W. W. Norton & Company, Inc., 1963), p. 92.

expenditures still further. His attitude was very much reflected in his State of the Union message on February 2, 1953, in which he promised to reduce planned deficits, balance the budget and check the menace of inflation.²

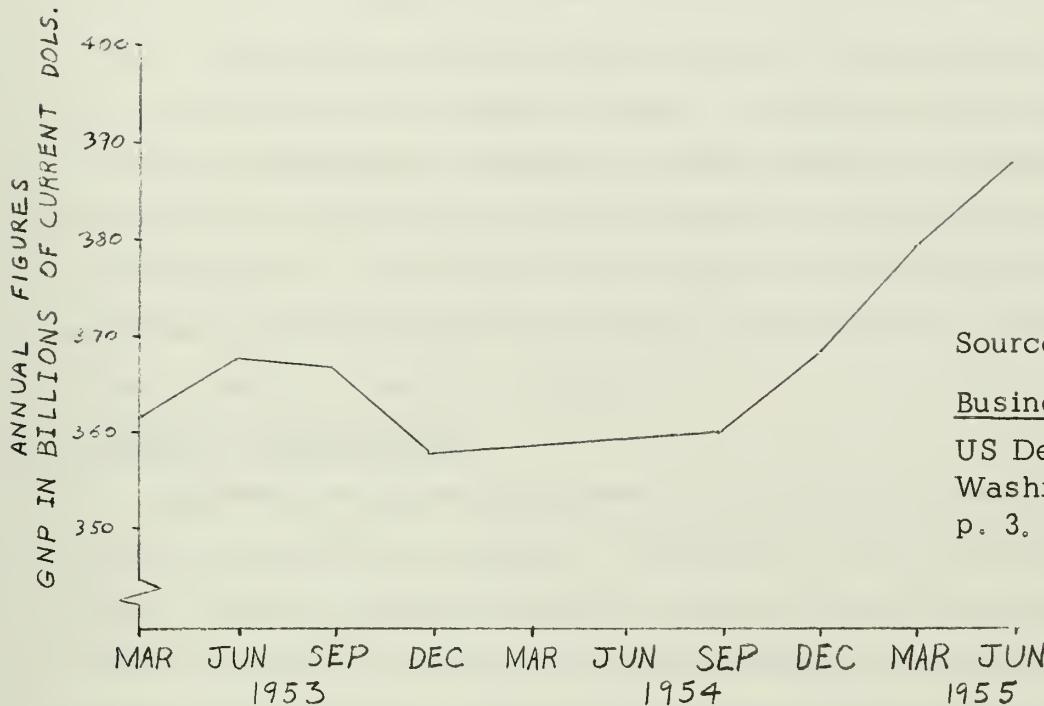
The eventual result of efforts to reduce the budget was that the military programs of the Department of Defense and the Atomic Energy Commission, together with foreign aid, accounted for \$5.6 billion of the total reduction of \$6.5 billion below the Truman estimates of budget expenditures. The short-run inflexibility in the federal budget is indicated by the fact that, in spite of the Administration's intensive efforts to trim expenditures, reductions outside the national defense and foreign aid categories were only modest.

It is also of considerable importance to an understanding of the recession, to point out that when President Eisenhower took office a number of major tax reductions were provided for by completed legislation. The wartime excess profits tax was scheduled to expire on June 30, 1953. Individual income tax rates were to drop by ten percent on January 1, 1954. And on April 1, 1954 the corporate tax rate was to be decreased from 52 percent to 47 percent, and certain temporary increases in excise taxes were to expire.

In an increased effort to balance the budget and curb expected inflation, the President requested an extension of the wartime excess profits taxes scheduled to expire on June 30, 1953. The President wanted

² Wilfred Lewis, Jr., Federal Fiscal Policy in the Postwar Recessions (Washington: The Brookings Institution, 1962), pp. 131-135.

FIGURE 5. GNP



Source:

Business Statistics,
US Dept of Commerce,
Washington, 1957,
p. 3.

Illustration of the drop in GNP during 1953-1954 recession. As indicated the downturn began in mid 1953 and reached bottom point at the end of that year. There was a total drop of approximately \$10 Bil. A gradual rise began in early 1954 and continued through the 3rd Qtr. A sharp upturn began in the 4th Qtr of 1954.

to extend these taxes through December 31, of that year, and Congress authorized the extension. At the same time there was a move in Congress to effect a ten percent reduction in personal income taxes as of July 1, 1953, which, as indicated above, was actually scheduled for January 1, 1954. The President objected to this change in plans and was successful in maintaining the original schedule. On June 1, 1953, Secretary of the Treasury Humphrey defended the Administration's recommendations for extension of the excess profits tax and no acceleration of the scheduled reductions of individual income taxes on the grounds that "further inflation must be stopped and the dollar must be kept sound to provide a solid base for a healthy economy."³

FEDERAL RESERVE POLICY

Apparently President Eisenhower and his advisors were not the only ones concerned about inflation. In January of 1953, the Federal Reserve Board, seeing a possible inflationary threat, raised the discount rate from 1-3/4 to 2 percent and sold government securities on the open market, in order to put pressure on member bank reserves. The Board's concern was largely the result of three years of steady growth of the money supply, a sharp increase in business loans from banks in the closing months of 1952, an upward drift in wholesale prices of industrial goods, and a price climb in consumer services.⁴ After taking what it considered moderate action

³ Ibid., pp. 131-138 .

⁴ Joint Economic Committee, Staff Report on Employment Growth and Price Levels (Washington: U. S. Government Printing Office, 1959), p. 329.

the Fed decided to pursue a policy of watchful waiting, not wishing to create too stringent conditions surrounding the availability of credit.⁵

This policy of caution, however, was disturbed when the Treasury announced in April, and threw onto the market for sale in May \$1.2 billion of long-term 3-1/4 percent bonds. The issue represented an avowed Treasury policy of lengthening debt maturities and embracing a higher interest rate structure. The 3-1/4 percent was carrying out the latter with inordinate determination since the yield on long-term government securities had reached only 2.87 percent in early March, 1953.⁶ The resulting further upward pressure on interest rates apparently seemed to the Federal Reserve authorities to create the possibility of an overly stringent credit policy in view of economic conditions and certain economic indicators by the second quarter of the year. (See Table I and Figure 6). The Board accordingly reversed itself, and entered the open market to make purchases in May and June, thus easing credit.⁷ This timely action by the Board to ease credit proved to be of considerable benefit to the outcome of the recession, particularly since it encouraged a sharp rise in residential construction.

⁵ Kenneth D. Roosa, "Business Fluctuations in the United States Since 1951", American Economic Review, May, 1955, pp. 384-387.

⁶ Ralph E. Freeman, "Postwar Monetary Policy," Postwar Economic Trends in the United States (New York: Harper, 1960), p. 70.

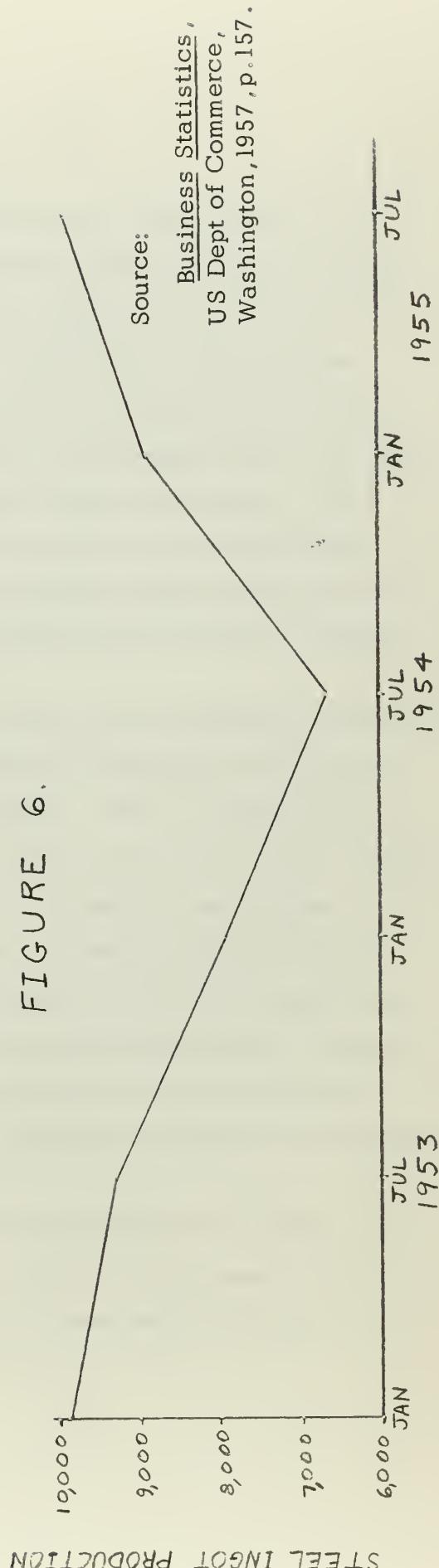
⁷ Vatter, op. cit., p. 91.

TABLE 1 ECONOMIC INDICATORS

| Year | 1953 | 1953 | 1953 | 1953 | 1954 | 1954 | 1954 | 1955 |
|----------------------------|-------|-------|-------|--------|-------|-------|-------|-------|
| Qtr. | 1st | 2nd | 3rd | 4th | 1st | 2nd | 3rd | 4th |
| Consumer Price Index | 113.6 | 114.1 | 115.2 | 114.9 | 114.8 | 115.1 | 114.7 | 114.3 |
| Wholesale Price Index | 109.8 | 109.6 | 110.0 | 110.11 | 110.5 | 110 | 110 | 109.5 |
| Industrial Prod. Index | 134 | 136 | 135 | 124 | 126 | 124 | 126 | 128 |
| Mfg. Weekly Hours | 41.0 | 40.7 | 39.9 | 40.2 | 39.5 | 39.5 | 39.7 | 40.5 |
| Freight Car Loadings Index | 121 | 130 | 126 | 117 | 112 | 111 | 111 | 123 |

Consumer and wholesale price indexes remained stable during the 1953-1954 recession. The industrial production index, mfg. weekly hours and freight car loadings index all dropped during the recession. In particular, the decrease in the freight car loadings index seems to fit in with the inventory disinvestment that occurred. This would also apply to the decrease in the industrial production index. Steel ingot production also dropped as shown below.

FIGURE 6.



CHANGE IN ATTITUDE

By September 1953 the Administration began to show signs of concern about the economic outlook. By that time there was unquestionable evidence of the impending recession. The evidence included the downturn in certain key economic indicators -- among them Weekly Manufacturing Hours, the Freight Car Loadings Index and Steel Ingot Production. Even more convincing was an upturn in the unemployment rate. And, of course, by this time the GNP had already begun to decrease. The President's reaction to these unfavorable indications as stated at his September cabinet meeting was that the Republican Party must be ready to use the full power of the government if necessary to prevent "another 1929."

In September task forces at the staff level were established under the auspices of the Council of Economic Advisors to examine the economic aspects of a number of governmental programs. These included house modernization and repair, federal credit aids to construction, public works, unemployment compensation, tax revision, community and business programs to expand employment and programs to strengthen the financial system. The thinking of the Council of Economic Advisors at that time was less in terms of increased government spending and more in terms of monetary policy, the activities of private business, tax reduction and government programs emphasizing loans rather than construction undertaken by the government itself.⁸

By January 1954, recognition that the economy was in recession was widespread. Retail sales were sluggish, and the unemployment rate continued to rise. In addition to the usual trio of messages to Congress, at

⁸Lewis, op. cit., p. 145 .

that time of year, there were an unusually large number of special messages covering such programs as housing, agriculture and social security. A review of antirecessionary policy actions already taken was presented in the President's Economic Report. The major ones were:

- (1) Federal Reserve action to ease credit during the previous May. This action -- while actually started before the turning point -- was most fortunate, and the ease with which it was done lends support to the view that monetary policy can be used with more flexibility than fiscal policy. Early action on the monetary front proved to be of considerable benefit, particularly in that it contributed to a highly desirable spurt in residential construction.
- (2) Tax reductions. As previously planned the wartime excess profits taxes expired in January, and the ten percent reduction in personal income taxes became effective.
- (3) Price supports and other aids extended the farmers. The stepped-up outlays for farm price supports, however, had offsetting effects in reducing the real income of consumers. The outlays were in response to changes in supply, rather than demand, and were largely automatic under the law. The administration's attitude toward such outlays is reflected in the fact that its proposals at that time featured flexible price supports, a euphemism for hoped-for reductions in government outlays.
- (4) Steps to improve and coordinate public works planning. This policy should actually be classified as a long-range

reform, or a hedge against more serious depression, since 1953-54 came and went without an effort by the administration to use such plans for economic stabilization.⁹

The Economic Report also listed a number of antirecessionary weapons available in case of need. They included: federal reserve credit controls; debt management techniques of the Treasury; presidential authority to alter terms of FHA-insured mortgages; the flexible administration of budget expenditures; taxation; public works; and newly recommended agricultural price supports.¹⁰

The administration's attitude during the early months of 1954 was one of preparedness and watchful waiting. They felt that the situation did not call for drastic action, but they were ready to move if and when it did. During this period, the goal of balancing the budget received muted emphasis. With the fate of the economy in the balance it was submerged under the determination of the administration to undertake those actions necessary to prevent a serious recession at any cost.

EXPENDITURE POLICY REVISED

By April the President had become increasingly concerned about the economic situation. The President's concern was partially the result of a continued rise in the unemployment rate, even though in March there were other indicators that had begun to show favorable signs. The list of possible immediate actions was reviewed, and in May the President

⁹ Ibid., pp. 150-152.

¹⁰ Ibid., p. 150 .

directed a speed-up of government expenditures budgeted for fiscal year 1955. In response to the President's remarks and instructions at the May 14 cabinet meeting, it was decided that the budgeting policy of the administration would be to increase expenditures on useful projects as rapidly as possible, wherever this could be done within the overall limits of expenditure totals already planned for fiscal 1955. From this it appears that the general plan was rather cautious in nature. Also items requiring legislation or supplemental appropriations were ruled out. And it was decided that the expenditure policy would be reversed in six months in order to leave fiscal 1955 total budgeted expenditures unchanged. Furthermore, in relation to the total budget, the amount involved in the expenditure speed-up was small, being roughly \$1 billion. It is likely, in fact, that the estimated \$2.25 billion increase in obligations corresponding to the increase in expenditures was actually psychologically more beneficial than the expenditures themselves. About 75 percent of the increase in expenditures and 85 percent of the increase in obligations were for Department of Defense military programs. DOD steps which were expected to have an expansionary impact included: requesting contractors to step up production and delivery rates; placing orders for the 1955 shipbuilding program earlier than planned; speeding up the award of contracts; and purchasing supplies for industrial and stock funds earlier than usual. Other departments and agencies involved in the speedup were Commerce, Interior, Agriculture, the Office of Defense Mobilization, and the General Services Administration.

¹¹ Ibid., pp. 162-169 .

THE RECOVERY

By July certain economic indicators began to turn upward. (See Table I and Fig. 6). There was an indication that the trough in GNP had passed, although unemployment did not reach its maximum rate of a little over six percent until a quarter later. Over the next year the GNP increased by \$34 billion, and by May 1955 unemployment declined to a rate of slightly over four percent. Expansion after mid 1954 was aided by a strong rise in residential construction which had started in the second quarter and a strong rise in consumption starting in the fourth. The latter, sparked by a sharp increase in the purchase of automobiles, continued to climb upward in mid 1955 having risen from a pre-recession peak of approximately \$232 billion in July 1953 to approximately \$252 billion in June 1955. The decline in federal spending was less steep after the middle of 1954, and expenditures remained fairly constant from the fourth quarter of 1954 through the third quarter of 1955. And liquidation of business inventories ceased in the final quarter of 1954, and was changed to accumulation starting in the first quarter of 1955.¹² The effects of the rise in consumption, the cessation of the decrease in government spending, and the upturn in investment combined to carry the economy out of the recession.

GNP COMPONENT BEHAVIOR

Consumption

In reviewing the 1953-54 recession in terms of the behavior of the various components of GNP, probably of greatest significance was the buoyancy of disposable income and, in turn, consumption. Subsequent to the peak in GNP in July 1953, and as the downturn continued into the fourth quarter, the automatic stabilizers acted as a cushion against

¹² Ibid., p. 171.

decreased disposable income. The automatic stabilizers were primarily in the form of reduced tax receipts, increased transfer payments, and reduced savings. (See Table III). Partially as a result of this, consumption expenditures were not seriously affected by the recession (See Figure 7 and Tables II and III). With the exception of a slight drop in late 1953, consumption continued to increase throughout the recession. In addition to the desirable effect of the built-in stabilizers, the lapsing of wartime excess profits taxes and the reduction in personal income taxes in January 1954, both contributed to the maintenance of stable consumption. Another important influence on consumption during this period was the deferred consumer demand that had accumulated during the Korean War.

The performance of disposable income and consumption constituted the primary explanation of the recession's mildness and, together with housebuilding, the ensuing recovery. The sustained rise in consumption acted as a moderating influence on the recession and as a base for recovery. Table III shows the magnitude of the increase in consumption along with the immediate explanations for it. The rise in consumption of \$5.4 billion demonstrates the autonomy from GNP that characterized consumption during the recession.¹³

¹³ Vatter, op. cit., pp. 93-94.

TABLE II
 Personal Consumption Expenditures by Major Spending Categories¹⁴
 1950-1955
 (in billions of 1954 dollars)

| | | | | | | |
|----------------------|-------|-------|-------|-------|-------|-------|
| Personal Consumption | 216.8 | 218.5 | 224.2 | 235.1 | 238.0 | 256.0 |
| Durables | 32.1 | 29.2 | 28.5 | 33.1 | 32.4 | 39.6 |
| Nondurables | 109.2 | 111.2 | 115.0 | 118.3 | 119.3 | 125.4 |
| Services | 75.5 | 78.2 | 80.0 | 83.7 | 86.3 | 91.0 |

¹⁴ Economic Report of the President (Washington: January, 1962), p. 210.

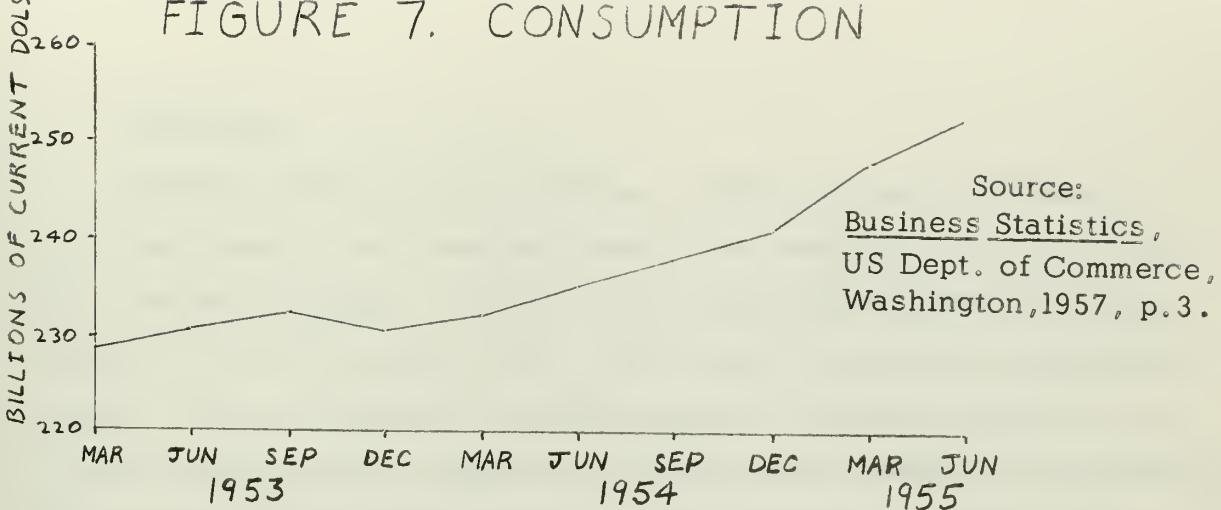
TABLE III

Personal Income, Consumption and Savings, 1953-54 Recessions¹⁵
 (amounts in seasonally adjusted annual rates in billions of dollars)

| | Pre-recession | | | |
|---|-----------------------------|------------------------------|-------------|--------------|
| | peak | trough | Change | |
| | (April, May, June, 1953) | (July, Aug., Sept., 1954) | Amount | Percent |
| Wage and salary disbursements | 198.8 | 195.4 | -3.4 | -1.7 |
| Private | 164.8 | 160.8 | -4.0 | -2.4 |
| Government | 34.0 | 34.6 | +0.6 | +1.8 |
| Transfer payments | 14.1 | 16.5 | +2.4 | +17.0 |
| Proprietor's Income | 40.7 | 40.9 | +0.2 | +0.5 |
| Business and professional | 27.5 | 27.8 | +0.3 | +1.1 |
| Farm | 13.2 | 13.1 | -0.1 | -0.8 |
| Property income | 33.2 | 35.3 | +2.1 | +6.3 |
| Rents | 10.5 | 10.9 | +0.4 | +3.8 |
| Dividends | 9.4 | 9.7 | +0.3 | +3.2 |
| Interest | 13.7 | 14.7 | +1.4 | +10.5 |
| Other income | <u>1.9</u> | <u>1.6</u> | <u>-0.3</u> | <u>-15.8</u> |
| Total personal income | 288.7 | 289.7 | +1.0 | +0.3 |
| Less: Personal tax and non-tax payments | 35.9 | 32.9 | -3.0 | -8.4 |
| Equals: Disposal income | 252.8 | 256.8 | +4.0 | +1.6 |
| Less: Personal consumption expenditures | 233.3 | 238.7 | +5.4 | +2.3 |
| Equals: Personal saving | 19.6 | 18.0 | -1.6 | -8.2 |

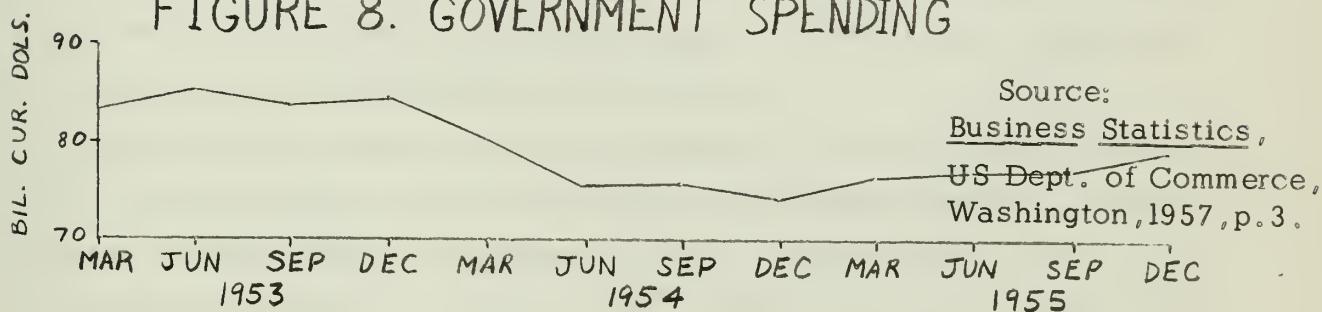
¹⁵ Federal Reserve Bank of St. Louis, Monthly Review (St. Louis: December, 1958), p. 148.

FIGURE 7. CONSUMPTION



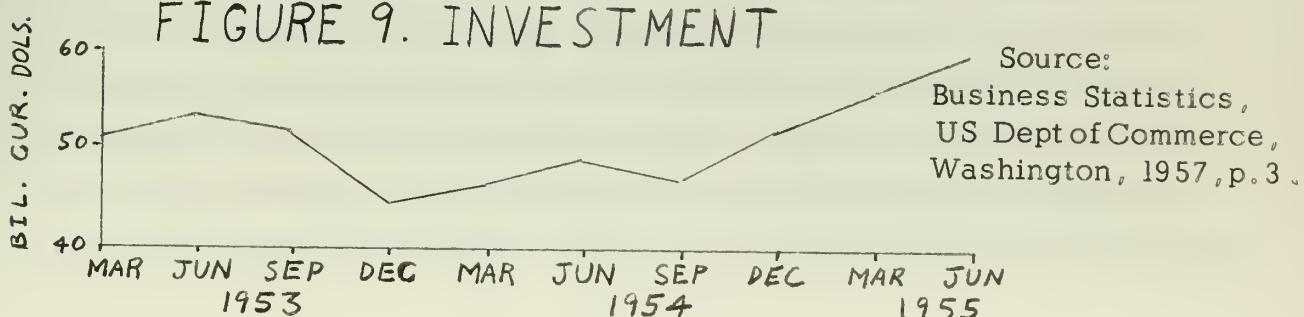
With the exception of a slight drop in late 1953, consumption continued to increase during the recession. This was largely due to: (1) deferred demand accumulated during the Korean War and (2) relaxation of wartime tax rates in early 1954.

FIGURE 8. GOVERNMENT SPENDING



Government spending declined and contributed to the drop in GNP. This was primarily due to the reduction in defense spending associated with the end of the Korean hostilities.

FIGURE 9. INVESTMENT



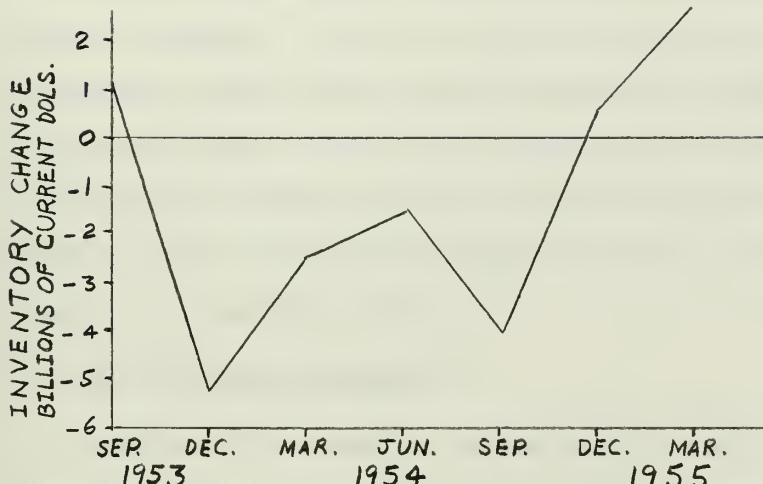
Investment decreased and contributed to the drop in GNP. This decline in investment was primarily the result of inventory shrinkage as shown in Figure 10.

Investment

Although consumption declined only slightly at one point, and in fact continued to rise throughout most of the recession, the rate of rise was somewhat sluggish. Retail sales in particular barely rose subsequent to the third quarter of 1952. As a result the reverse "acceleration effect" was set in motion, and this induced an absolute decline in investment following the appearance of unexpected inventory accumulations. The decline in investment, therefore, was largely in the nature of an inventory disinvestment on the part of businessmen. The magnitude of the decline, which was from an annual rate of about \$53 billion in June 1953 to about \$44.5 billion in December of that year, is illustrated in Figure 9. The size of the inventory disinvestment is shown in Figure 10. As can be seen from the graphs the upturn in investment came in late 1954 as the rate of consumption spending began to increase more rapidly and as businessmen began placing orders again.

The long-term share of business investment, though slightly sensitive to the recession, rode it out with only a moderate decline. Expenditures for new plant and equipment fell from a peak of \$28.8 billion in the third quarter of 1953 to a trough of \$25.7 billion in the first quarter of 1955. The decline was widely diffused, the commercial and public utilities sector being among the least affected. The moderateness of the decline in long-term investment has been attributed to a combination of the mildness and brevity of the recession drop in total spending, the stickiness of prices during the period, the favorable sales prospects that emerged from the strong performance of total consumption and housing, and the strength of the corporate financial position. Business investment was also much encouraged by satisfactory profits and cash flow. The expiration of the Korean War excess profits tax in January 1954 and the offsetting

FIGURE 10.
INVENTORY CHANGE



Source:
Business Statistics
U.S. Dept. of Commerce,
Washington, 1957, p.3.

Figure 10 illustrates the inventory dis-investment by businessmen during 1953-1954 recession.

NET FOREIGN INVESTMENT

TABLE IV

| Year | Qtr. | Amt. | * |
|------|------|------|------------------------------------|
| 1953 | 1 | -2.1 | Net foreign investment rose from |
| | 2 | -3.0 | a minus \$2.1 billion in the first |
| | 3 | -1.4 | quarter of 1954 to a minus \$0.7 |
| | 4 | -1.7 | billion in the second quarter of |
| 1954 | 1 | -1.1 | 1955. |
| | 2 | -0.2 | |
| | 3 | -0.7 | |
| | 4 | +0.3 | * Billions of dollars |
| 1955 | 1 | -0.4 | |
| | 2 | -0.7 | |

Source:
Business Statistics
U.S. Dept. of Commerce
Washington, 1957, p.3.

of the fall in corporate profits in 1954 by a decrease in corporate tax liabilities also contributed to the moderateness of the decline in long-term investment. The tax decrease completely absorbed the decline in corporate profits before taxes between 1953 and 1954. And aggregate corporate profits after taxes in both years were higher than in 1952. The institutional features of the economic environment therefore acted not only to bolster disposable income, but also to cushion the effect of contraction on business profits.¹⁶

Net Foreign Investment

Also worthy of mention is the boost in net foreign investment which occurred during the period of the 1953-54 recession. The rise was due primarily to a slight rise in exports combined with a decline in imports. Reversal about mid 1953 of an export decline that had persisted since early 1951 has been attributed for the most part to the industrial expansion of Western Europe and the United Kingdom in 1953 and 1954¹⁷. The rise in net foreign investment during this period is illustrated in Table IV.

Government Spending

Being the major cause of the recession, the decrease in government spending associated with the end of the Korean War has been extensively discussed in previous sections of this chapter. The decline in government spending was from an annual rate of approximately \$85 billion in June of 1953 to approximately \$75 billion in December of 1954. This decrease is illustrated graphically in Figure 8.

In addition to the decrease in defense expenditures after the war, it has been pointed out that the Eisenhower administration attempted

¹⁶ Vatter, op. cit., pp. 94-95.

¹⁷ Ibid., p. 93.

to decrease federal expenditures still further during the early part of the recession. The President's program at that time suggests a conflict between stabilization and budget goals.

Despite the plans in May 1954 to speed-up expenditures by \$1 billion of fiscal 1955 funds, it appears that the actual increases were much less than planned. Lewis has compiled a tabulation of the estimated effects of the defense portion of the speed-up. This data is presented in Table V.

TABLE V
ESTIMATED EFFECTS OF ANTI RECESSION DEFENSE SPEED-UP
ON OBLIGATIONS AND EXPENDITURES, FISCAL YEAR 1955¹⁸
(in billions of dollars)

| Quarters | Obligations | Expenditures |
|-------------------|-------------|--------------|
| July-Sept. 1954 | 0.5 | -- |
| Oct-Dec. 1954 | 2.0 | 0.1 |
| Jan-Mar. 1955 | -1.0 | 0.4 |
| April-June 1955 | <u>-1.5</u> | <u>-0.1</u> |
| Fiscal Year Total | -- | 0.4 |

The rescheduling of expenditures did not actually take effect until the second quarter of the fiscal year and then only amounted to \$0.1 billion. There was a further increase of \$0.4 billion in the third quarter, but this still fell far short of the planned speed-up. Attempts to speed-up obliga-

¹⁸Lewis, op. cit., p. 179.

tions, however, appear to have been successful with a \$0.5 billion increase in the first quarter of the fiscal year and an additional \$2.0 billion in the second quarter.

CONCLUSION

The 1953-1954 recession was the mildest of the three recessions that occurred during the decade of the 50's. There was a \$10 billion, 2.7% drop in GNP compared with \$9.5 billion, 3.6% in 1948-50 and \$15.4 billion, 3.4% in 1957-58. The decline in government expenditures associated with the end of the Korean War was the major cause of the recession. A secondary cause was the decrease in investment which was largely in the nature of an inventory disinvestment on the part of businessmen. The buoyant performance of disposable income, and in turn consumption, contributed to the mildness of the recession, and together with house-building, the ensuing recovery.

Considering the magnitude of the decrease in defense expenditures facing the government, it appears that the authorities were fairly effective in combating the recession. The Federal Reserve Board's application of discretionary monetary policy by easing credit through the purchase of government securities and later by reducing the rediscount rate, stimulated the residential building program and eventually encouraged investment on the part of businessmen.

From the vantage point of hindsight, perhaps the major error committed was in not allowing the excess profits tax and individual income tax cuts to take place on July 1, 1953, rather than six months later. This was the date already scheduled for expiration of the excess profits tax and the date strongly pushed for individual income tax cuts by key Congressional leaders. There was strong evidence of the impending recession by several key economic indicators, in particular Weekly Manufacturing Hours and

Steel Ingot Production, both of which turned downward in the second quarter of 1953. The decline in defense spending turned out to be much greater than originally anticipated, and as late as January 1954 was still seriously underestimated. Nevertheless, a cutback in defense spending, even of the smaller size contemplated earlier, probably could not have been digested by the economy -- in the absence of tax cuts -- without a setback. The failure to schedule tax cuts earlier was caused by: lingering concern about inflationary tendencies, uncertainty about the response of the economy to removal of direct controls carried over from the Korean War, and the independent importance attached to balanced budgets, *per se*.¹⁹ In defense of the administration, however, it is pointed out that unemployment remained at an unusually low rate of 2.7 percent up until September 1955. Therefore, concern over potential inflation up until that time was not completely unreasonable.

Discretionary counterrecession expenditure actions were slow to be initiated and were modest in scope -- being limited for the most part to within-year shifts of government expenditures. A general speed-up of expenditures was finally initiated in May 1954 after certain economic indicators had begun to show a favorable tendency. The circumstances surrounding the speed-up, to be reversed after six months, suggest that the administration was fairly confident that a turning point in the economy was imminent, and that the purpose of the speed-up was to hasten, or strengthen the recovery rather than to initiate an otherwise doubtful turning point.

That there may have been some conflict between budgetary and stabilization goals is borne out by the fact that the actual federal surplus reached a rate of \$3.5 billion in the second quarter of 1955, compared with a deficit of \$7 billion at the prerecession peak two years earlier. This switch

¹⁹ *Ibid.*, pp. 183-185.

from a \$7 billion deficit to a \$3.5 billion surplus occurred while unemployment rose from a rate of 2.6 percent before the recession to upwards of 6 percent in the middle of the recession, finally leveling off at about 4 percent in mid 1955.²⁰

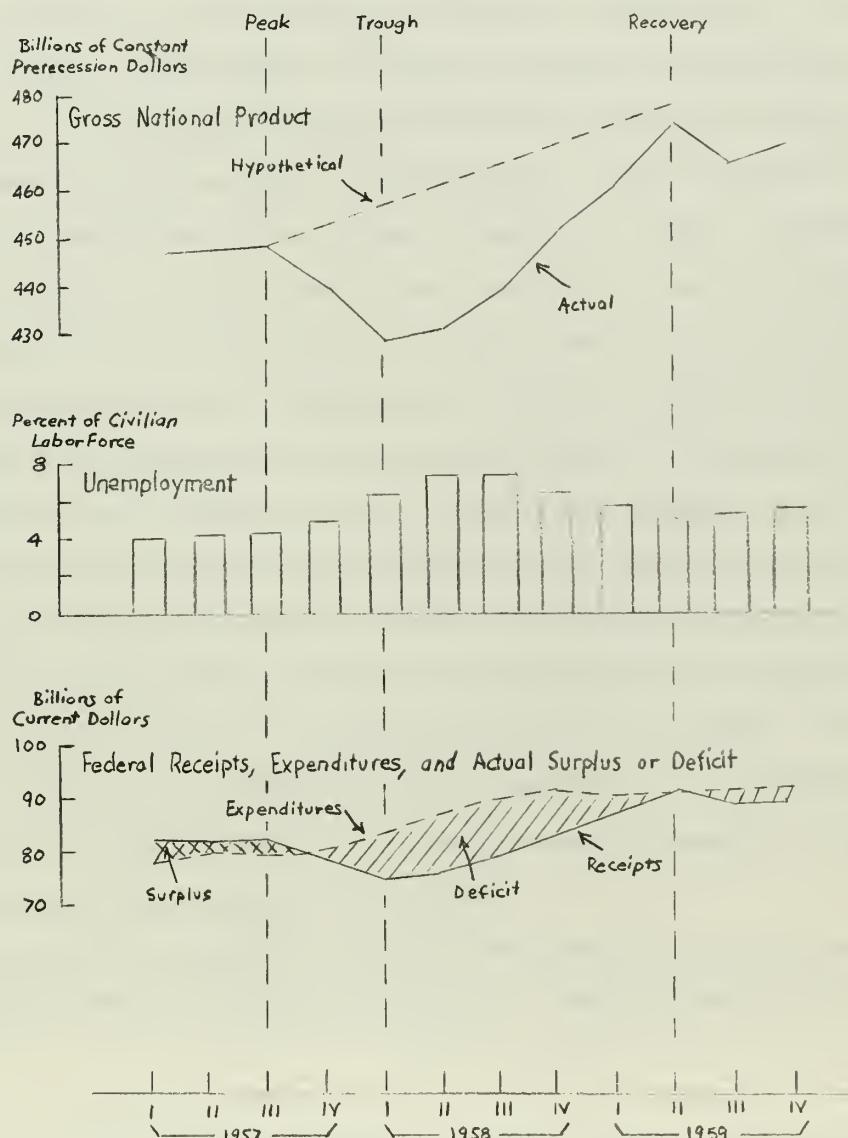
By the end of 1954 some indications of the 1955-1956 boom period were beginning to become apparent. It appears, therefore, that in the recovery from the recession of 1953-1954, a potentially too-tight fiscal policy was redeemed by the emergence of inflationary pressures from unexpected quarters. In short, had the inflationary period beginning in 1955 not been forthcoming, the government may have been forced to pursue a policy calling for increased government expenditure.

²⁰ Ibid., p. 187.

CHAPTER VI

THE RECESSION OF 1957-1958

The 1957-58 recession has frequently been described as a "classical" or "text-book" example of business contraction. This is due primarily to the fact that it was the first postwar period recession which was free of war influences and because of the earlier and somewhat larger



Source:
Survey of Current Business

FIGURE 11
GNP, UNEMPLOYMENT, AND FEDERAL RECEIPTS AND EXPENDITURES

role played by business fixed investment. It is also unique in that its sharp decline caused a Republican Administration and a Democratic Congress to attempt to outdo each other in adding to the expenditure side of the Federal budget.

CAUSES OF THE RECESSION

The seeds of the 1957-58 recession were sown in the great consumer spending boom of 1955. This unusual jump in consumer spending was revealed in a study made by Professor Daniel Suits, director of the University of Michigan's Research Seminar in Quantitative Economics. In terms of past relations between consumer spending and income, taxes, liquid assets, and population, Suits calculated that consumption should have risen some \$11-billion in 1955. However, it jumped \$18-billion. The biggest factor behind this extra \$7-billion jump in buying was an increase in consumer debt, which rose \$5.8-billion in 1955 compared with an \$0.5-billion rise in 1954. This jump was highlighted by a housing boom, as consumers added \$12.5-billion to their mortgage debt, and needless to say, Detroit had a banner year.¹

Business firms began to lay in heavier inventories and as production began to move toward capacity, industry boosted new orders for capital goods. The resultant flow of money for new plants and equipment shot up and the boom was on. This trend continued on into 1957, but between the end of 1955 and mid 1957 something went wrong. The economic thorn turned out to be the fact that the consumer couldn't keep up with the tremendous pace being set by the producer.

While business capital spending stimulated by the 1955 spending rush plunged upward, consumer borrowing, spending and income stopped

¹"How the Slump Got That Way" Business Week, 1492 (April 5, 1958), 25.

its abnormal surge and returned to a normal or slightly below normal pace. Thus a profit squeeze was generated as the economy had generated capacity faster than demand.

The Federal Reserve Board, in an attempt to head off an inflationary trend, tightened up the money market, which, although it had virtually no effect on capital spending, did hurt housing. The tight money made the fixed-rate government insured mortgages far less attractive to investors than other higher-yield investments. This fall off in housing construction had the expected effect on other consumer durables. Thus the gap between rising capacity and a more slowly rising consumption was widened. This action coupled by a severe cutback in defense spending in the second half of 1957 proved to be the cause of this recession.²

VIEW FROM THE WHITE HOUSE

Steering the nation through the varying courses and currents of economic change is no small task and President Eisenhower, realizing this early in his first term, had relied on the sound advice offered him by his advisors in successfully combating the recession of 1953-54. However, two of the key men of his economic brain trust, George Humphrey and Arthur Burns had been replaced by Robert Anderson and Raymond Saulnier by 1957 as Secretary of the Treasury and Chairman of the Council of Economic Advisors, respectively. The task of recognizing current economic trends was now in their hands.

² Ibid., p. 27.

Saulnier³ was the first to apprise the president of the fact that the economy seemed to be slowing down and that there was an absence of latent strength powerful enough to push it anew onto substantially higher ground. He felt the "kick" was going out of the inflationary push and that an easing in the Federal Reserve Board's tight credit policy was called for. This view was proffered in the early summer of 1957.

Saulnier based his opinion on several leading trend indicators. Among which were: (1) average hours worked in basic manufacturing, (2) new orders for durable good, (3) stock market prices, (4) spot market commodity prices (5) business failures, and (6) industrial and residential construction contracts.⁴

His view was a minority opinion at the time, as the Chairman of the Federal Reserve Board, W. M. Martin, as well as the Treasury Secretary, felt the immediate danger to the economy was inflation.

By July, Saulnier had lost all hope of a new upsurge, but he felt that a timely easing in the Fed's credit policy would right the economy before a really serious disturbance occurred. Mr. Martin still disagreed, and felt his tight money policy was still the correct one to pursue, and in tact even raised the discount rate further in August. Saulnier voiced his disapproval to no avail.

About this time the 1959 budget was in preparation and it was constructed on the assumption that federal expenditures could be shrunk to

³ Raymond Saulnier, (Ph.D. Economics, Columbia) a former college professor at Barnard, had been an advisor to the Department of Agriculture during the Truman administration. He had served as a consultant to, and as a member of the Council of Economic Advisors prior to becoming its chairman.

⁴ Charles J. V. Murphy, "The White House and the Recession," Fortune, May 1958, p. 108.

to \$68-billion and that revenues could reach as much as \$76.6-billion, with full employment. A surplus of that sort would seem to justify a large tax cut, and Saulnier felt that this would bolster purchasing power and provide fresh incentives for investment. This hope went into orbit with Sputnik I.

In October, with the advent of the Russian satellite, Congress, the press and many powerful public figures joined together in demanding a mighty step-up in military spending. At the same time, the economic indicators turned down, and Saulnier became certain that a recession had begun. Saulnier expressed his views in a meeting of what was known as the "Little Four"; Secretary Anderson, Chairman Martin, presidential advisor Gabriel Hauge, Saulnier and the President. Again Saulnier was expressing a minority view. The others still felt that inflation was the big problem. Mr. Martin, in addition, felt that open-market operations, being initiated by the Fed, would cure any dip in business activity.⁵

In the second meeting of this group in November, Saulnier introduced new data that had been worked up, on then relatively new electronic computers, by Julius Shiskin, the chief economic statistician of the Census Bureau. This data proved convincing and two days later the FED reduced the discount rate from 3-1/2 to 3 percent. Through the unceasing efforts of Mr. Saulnier the budget presented to Congress in January 1959 was changed to reflect prudent fiscal policy and totalled \$73.9-billion, thus showing an apparent surplus of some \$500-million, a far cry from the large surplus indicated earlier.⁶

⁵ Ibid., p. 242.

⁶ Ibid., p. 244.

By January, the President's public statements implied that there was no immediate need for action to fight recession, even though he was well aware that the recession had arrived. He continued to blame politics for recession talk. He reaffirmed Mr. Martin's views at a news conference on the 15th when he described monetary policy as the powerful tool that would stimulate the economy. Democratic and Republican party leaders continued to debate whether or not the recession was at hand, and the January unemployment figures seemed to be the clinching piece of evident that convinced both groups that the recession was here. On March 8, 1958, the President, in letters to the minority leaders of Congress took his first active steps in combating the recession.⁷

These letters described his view of the government's role in the growth and vigor of the economy. He felt that the government should stimulate private production and employment and that public spending should not replace private spending. He listed the following steps that were being taken by the administration:

1. An acceleration of civil public works projects.
2. The release of \$200-million from the President's discretionary fund for FNMA special assistant mortgage purchases.
3. The award of more defense contracts to labor surplus areas.
4. An increase in the discount allowance on VA-guaranteed mortgages.
5. A liberalization of lending rules by Federal Home Loan Banks.

His proposals for congressional action were:

1. Supplementary appropriations for the coming fiscal year in order to allow the speed-up in public works.

⁷ Wilfred Lewis, Jr., Federal Fiscal Policy in the Postwar Recessions (Washington: The Brookings Institute, 1962), p. 204.

2. A three-year suspension of expenditure limitations in the Highway Act to permit apportionment of an additional \$2.2-billion of federal funds to the states over a three year period.
3. A temporary extension of the duration period of unemployment benefits.⁸

The President described the steps that the administration was taking as projects that were useful and needed in themselves, and as ones that would start quickly, provide employment quickly and not drag out so long as to compete with the needs of private enterprise when recovery came. The President's emphasis on speed and reversibility indicated his preference for his particular proposals over others now being discussed in Congress. On 19 March 1958 he initiated five more steps to speed up expenditures. They were:

1. Reserves were being released on \$100 million in balances of authorizations for the public facility loan program, and the HHFA was to broaden loan eligibility and take steps to accelerate the starting of new projects.
2. Starts on college housing were to be expedited where planning was completed or substantially completed, again liberalizing loan eligibility where necessary.
3. Urban renewal projects were to be expedited, broadening the types of construction eligible for authorized financing where necessary.
4. In cooperation with local authorities, steps were to be taken to speed construction of public housing under annual contributions contracts.

⁸ Ibid., p. 208.

5. The Rural Electrification Administration (REA) was to encourage faster construction by REA borrowers and loans to REA consumers for purchase of electrical equipment.⁹

Additional administrative actions were announced the next day. The Secretary of Agriculture said loan criteria were being liberalized, and loans encouraged by the Farmers Home Administration and by the Commodity Credit Corporation. An earlier than usual announcement of fiscal 1959 allocations to states for airport construction was made, and the Small Business Administration got in the act by reducing its underwriting fee on deferred participation loans.

The possibility of a tax cut had been a much discussed proposal in public forums and the President revealed the following at his March 26 news conference. He said that tax cuts were a possibility, but that this was a serious step and not one that he was going to be stampeded into. He revealed that Mr. Anderson had reached an agreement with democratic congressional leaders that nothing would be done on taxes before bipartisan consultation. This "gentleman's agreement" was primarily a move to head off a threatening race between the two parties as to who would be able to claim credit in an election year.¹⁰

ADMINISTRATIVE MEASURES

The steps taken by the administration to combat the recession were:

1. Speed-up in construction rates on direct federal public works already under way -- primarily water resource projects.

2. Encouragement of faster private, state and local government action on urban renewal, college housing, community facilities under

⁹ Ibid., pp. 209-210.

¹⁰ Ibid., p. 211.

federal loans, public housing, airports, hospitals, and construction supported by loans to REA cooperatives. In some of these cases, funds that had been held in reserve were released or apportioned to the agencies for spending earlier than they might have been in the normal course of events. In other cases, the action consisted of exhortation only.

3. Speed-up within fiscal 1958 of agency procurement of supplies, materials and equipment.

4. Speed-up early in calendar 1958 of processing and payment of tax refunds.

5. Liberalization of FHA and VA housing credit rules and speed-up in processing FHA loan applications.

6. Release of budgetary reserves in various FNMA special assistance mortgage purchase programs.

7. Liberalization of eligibility rules for Farmers Home Administration loans.

8. Emphasis on labor surplus areas in procurement contracts placed by the Department of Defense and the General Services Administration.¹¹

The administrative speed-up of public works projects appears to have added some \$50-million to \$100-million in fiscal 1958 and about \$175-million in fiscal 1959. As shown in table VI the refunds of individual income tax were much more successfully speeded up in 1958 than they had been in the 1954 recession. The table shows that refunds in March and April 1958 were about \$600-million higher. The welfare aspects of a speed-up of this kind are certainly favorable, particularly

¹¹Ibid., pp. 221-222.

TABLE VI¹²REFUNDS OF INDIVIDUAL INCOME TAX, RECESSION YEARS
COMPARED TO PRECEDING YEARS(Cumulative percentage of total paid by end of month and
dollar amount for year)

| End of Month | Prerecession 1953 | Prerecession 1954 | Prerecession 1957 | Prerecession 1958 |
|-------------------------|-------------------|-------------------|-------------------|-------------------|
| January | 1.7 | 1.9 | 0.8 | —1.3 |
| February ... | 12.6 | 11.2 | 5.3 | 3.8 |
| March ... | 43.3 | 39.6 | 21.6 | 24.8 |
| April | 74.6 | 67.0 | 52.4 | 67.1 |
| May | 82.5 | 85.5 | 81.5 | 90.5 |
| June | 87.6 | 90.0 | 91.6 | 93.5 |
| July | 90.0 | 92.5 | 94.1 | 95.5 |
| August.... | 92.9 | 94.6 | 96.2 | 97.0 |
| September .. | 93.5 | 94.8 | 97.6 | 98.3 |
| October.... | 95.9 | 95.9 | 98.6 | 99.1 |
| November ... | 97.8 | 97.6 | 99.4 | 99.7 |
| December .. | 100.8 | 100.0 | 100.0 | 100.0 |
| Amount (in millions) | \$3,070 | \$3,293 | \$3,484 | \$3,801 |

¹²Ibid., p. 223.

for those whose refunds stem from unemployment during the previous year.

The 1958 housing boom featured a rise of 40 percent in residential construction between the second quarter of 1958 and the second quarter of 1959, and was one of the strong factors in the recovery. Administration actions releasing housing reserves and affecting mortgage terms probably played some part in this expansion of private construction. However, administration actions on housing terms were probably less significant than the April 1 down-payment liberalization on FHA loans, which required legislation. The real cause of the boom was probably due to increased mortgage credit availability, which was a result of the FED's easing actions.¹³

LEGISLATIVE MEASURES

Of much more significance in 1958 were the anti-recessionary actions of the congress. There were four items among the many legislations passed that were clearly anti-recessionary. They were:

1. Temporary extended unemployment compensation (P.L. 85-441, June 4, 1958) provided federal funds with which states could pay benefits to unemployed individuals who exhausted their benefit rights for half again as long as they were able to collect under the regular state unemployment compensation systems.
2. The legislation on advance procurement (P.L. 85-386, April 24, 1958) authorized agencies other than the Department of Defense to order (or buy) in 1958, if possible, up to 50 percent of amounts proposed in the January budget for 1959 supplies, materials, and equipment to be charged against 1959 appropriations when finally enacted.

¹³ Ibid., pp. 223-224.

3. The Highway Act of 1958 (P.L. 85-381, April 16) increased:

(a) 1959 authorizations for interstate, ABC (primary, secondary, and urban), and forest and public lands highways; (b) 1960 and 1961 authorizations for interstate highways; and (c) 1961 authorizations for forest and public lands highways. In addition, it provided for an advance to 1959 of ABC authorizations to be repaid from 1961 and 1962 authorizations. To make apportionments to the states against these various authorizations possible, it waived, with respect to apportionment of the 1959 and 1960 authorizations, the pay-as-you-go requirement of the basic highway legislation.

4. The Housing Act of 1958 (P.L. 85-364, April 1) authorized, among other things, a reduction in minimum down payments on FHA-insured mortgages; \$1 billion for special assistance purchase by FNMA of mortgages on new homes costing \$13,500 or less; and an increase in the interest rate limit on VA-guaranteed loans. Other provisions, such as renewal of VA's expiring direct loan program, may also have had some counter-recession aspects, but would probably have occurred anyway.¹⁴

The fiscal impact of these measures is estimated in table VII.

The temporary extension of unemployment compensation undoubtedly had a prompt and stable economic impact during the recovery. Although transfer payments in general probably have a smaller total impact on aggregate demand per dollar of outlay than government purchases on goods and services, the extended unemployment compensation was probably relatively efficient in this respect since it went to individuals with presumably high re-spending propensities.

¹⁴Ibid., pp. 225-226.

TABLE VII¹⁵
 ESTIMATED IMPACT OF MAJOR 1958 ANTIRECESSION
 LEGISLATION ON BUDGET OR TRUST FUND
 (in millions of dollars)

| <u>Legislation</u> | <u>Fiscal Year Increase in Expenditures</u> | | | |
|---|---|-------------|-------------|---------------------------|
| | <u>1958</u> | <u>1959</u> | <u>1960</u> | <u>1961 and later</u> |
| Temporary extended unemployment compensation | 48 | 447 | -13 | -482 |
| Advance procurement, 1959 supplies and equipment | 6 | -6 | ... | ... |
| Federal aid to highways: | | | | |
| ABC (primary, secondary and urban) | ... | 262 | 241 | -103 |
| Interstate and forest and lands highways | ... | 20 | 156 | 334 |
| FNMA special assistance mortgage purchases, low-cost housing: | | | | |
| Purchases | ... | 657 | 186 | ... |
| Repayments | ... | -4 | -14 | -839 |
| Total budget and Highway trust funds | 54 | 1,376 | 556 | 1,090 |

¹⁵ Ibid., p. 226.

The effect of advance procurement in fiscal 1958 of 1959 supplies and equipment for nondefense agencies had little success. Reasons for the failure in this area included lack of storage space, insufficient time, long term commitments and the apparent facts that established agency practices and procedures are extremely resistant to change and that procurement items of significant magnitude are apt to require a long lead time.

The federal aid to highways was quite successful and construction approved by the Bureau of Public Roads in December 1958 was about 95 percent completed by the target date of December 1, 1959.

The FNMA program of special assistance purchase of mortgages on newly constructed low-cost houses appears to have been a relatively inefficient anti-recession device, in that construction was increased by substantially less than federal outlays. While the entire \$1-billion in special assistance funds was committed by the end of calendar 1958, builders stockpiled commitments received from FNMA, and a substantial portion remained unused until 1959 building season. More important, the initial injection of funds came at a time when mortgage money was plentiful, and the competition for available mortgages active. The state of the mortgage market was indicated by the large volume of mortgages FNMA was able to sell under its secondary market operations which were governed by general mortgage market conditions rather than anti-recession motives.¹⁶

THE FED'S ACTIVITIES

The FED first recognized the trend shift from inflation to recession in November of 1958. Its first actions were to direct its open market operations to supplying reserves more liberally to the banking system. It

¹⁶ Ibid., pp. 226-229.

also reduced the discount rates on member bank borrowings at this time. As the stream of factual information continued to verify the presence of the recession, the FED's actions and policies became more aggressive and discount rate, open market and reserve requirement instruments were actively applied in complementary fashion to foster ease in credit markets and encourage bank credit and monetary expansion.

From November 1957 until April 1958, there were four reductions in Federal Reserve discount rates, from 3-1/2 percent to 1-3/4 percent. At the same time the Reserve System supplied commercial banks with some \$2-billion of reserve funds through open market operations. In addition, the System, through three successive reserve requirement reductions, released for the use of member banks about \$1.5-billion of their required reserves. The total amount of reserve funds supplied by the System to commercial banks during this period, actually from November 1957 to July 1958, was enough to enable member banks to reduce their discounts at Reserve Banks from \$800-million to about \$100-million, to offset sales of gold to foreign countries amounting to \$1.5-billion, and to finance a commercial bank credit expansion of almost \$8-billion. Finally, early in January 1958 the FED reduced the margin requirement from 70 to 50 percent.¹⁷

¹⁷ William McChesney Martin, Jr., "A Year of Recession and Recovery," Federal Reserve Bulletin, 45:2, February, 1959, pp. 110-111.

CONCLUSION

A quick glance at Table VIII shows what happened to the various components of the GNP, from peak to trough.

| | <u>Billions of Dollars</u> | <u>Percent</u> |
|------------------------|----------------------------|----------------|
| Consumption | -4.5 | -1.6 |
| Private Investment | -12.1 | -20.6 |
| Government Purchases | +2.2 | 2.9 |
| Net Foreign Investment | -3.4 | -89.0 |
| GNP | -17.8 | -4.1 |

TABLE VIII
DECLINE OF SPENDING TRENDS

Source: Survey of Current Business

It is clearly shown here that the recession was registered for the most part as a private investment slump, and as had been the case in 1953, inventory disinvestment accounted for the bulk of the loss in investment, followed by producer's durable equipment. Note the small change of the consumption component, which indicates the extreme stability of consumer spending for non-durables and services.

The persistency of inflation after the onset of decline, and the uncertainty in the immediate post-Sputnik period about what levels of defense and space research might be required in the future, were major factors in the administration's delay in acknowledging the recession and proposing corrective actions.

Once the fact that the recession was here was acknowledged, the administration still held onto the idea that no anti-cyclical action by

the government would be necessary as it felt that the inherent strength of the economy would stem the decline. This view soon proved untenable and government intercession was started. The administration excluded the Department of Defense activities from its speed up policies and thus these activities proved to be ineffective due to their meagerness. The facts that 1958 was an election year, that congress was controlled by "LBJ" and "Mr. Sam" and that the administration really had no plan of attack all combined to take the initiative for counter-recession activity from the Executive.

The estimated fiscal effects of the 1958 discretionary anti-recession actions, along with other factors affecting the federal budget during the period in question are shown in table IX.

Note in table IX that the swing from surplus to deficit in the federal fiscal budget over the period of contraction was almost wholly the work of the built-in fiscal stabilizers. Also note that discretionary anti-recession actions weren't even in effect by the trough quarter, and that they made their peak contribution in the last quarter of 1958. More important during the recovery than these actions were those taken for other reasons. The effect of such actions as increased expenditures for post-Sputnik defense actions, farm price supports and the reduction in transportation excises more than outweighed the increase in revenues that would have taken place at continued high-employment. As a result, the implicit federal surplus would have declined during the recovery period, even in the absence of discretionary anti-recession spending. Taking all factors into consideration, the implicit surplus declined by \$2.3-billion during the recovery.¹⁸

¹⁸ Lewis, op. cit., pp. 231-233.

| Item | 1957 III-4 | 1957 IV | 1958 I-7 | Change Peak to Trough | 1958 II | 1958 III | 1958 IV | 1959 I | 1959 II | Change Trough to Terminal (B) |
|--|---------------|------------|-------------|-----------------------------|------------|-------------|------------|-----------|------------|--|
| Surplus at precession point | 2.6 | 2.6 | 2.6 | ... | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 | ... |
| Factors not due to recession | | | | | | | | | | |
| Increased receipts, high employment, constant precession tax rates | 1.1 | 2.2 | 2.2 | 3.2 | 4.3 | 5.4 | 6.4 | 7.5 | 8.3 | |
| Plus: OASI payroll taxes— | | | | | | | | | | |
| Increase, taxable wage base | ... | ... | ... | ... | ... | ... | ... | 0.9 | 0.9 | 0.9 |
| Increase, payroll tax rate | ... | ... | ... | ... | ... | ... | ... | 0.9 | 0.9 | 0.9 |
| Less: tax reductions— | | | | | | | | | | |
| Expiration, excise on freight transport | ... | ... | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | — |
| Liberalized tax on small business | ... | ... | ... | ... | ... | ... | ... | ... | ... | |
| Less: expenditure increase— | | | | | | | | | | |
| Purchases, goods and services | -1.0 | -0.6 | -0.6 | -0.4 | -0.1 | -0.5 | 0.9 | 1.5 | 2.1 | |
| National defense | 0.4 | 1.3 | 1.3 | 2.2 | 2.5 | 3.8 | 2.0 | 2.1 | 0.4 | |
| Other | 0.5 | 1.9 | 1.9 | 2.9 | 2.1 | 2.3 | 3.3 | 4.2 | 3.2 | |
| Transfer payments to persons | 0.2 | — | — | 0.1 | — | 0.4 | 0.3 | 0.2 | 0.2 | |
| Transfer payments abroad | — | — | — | — | — | — | — | — | — | |
| Grants to state and local governments | -0.1 | 0.6 | 0.4 | 1.1 | 1.3 | 1.5 | 2.2 | 2.1 | 1.5 | |
| Net interest paid | -0.2 | -0.2 | -0.2 | -0.3 | -0.3 | -0.1 | 0.2 | 0.4 | 0.6 | |
| Subsidies less current surpluses of government enterprises | -0.2 | 0.1 | 0.1 | 0.2 | 0.2 | 0.2 | -0.1 | -0.2 | -0.3 | |
| Subtotal = precession surplus adjusted for factors not due to recessions | 2.6 | 3.9 | 2.4 | -0.2 | 0.7 | -0.5 | -1.3 | 1.3 | 0.9 | -1.3 |
| Less: discretionary antirecession expenditures | | | | | | | | | | |
| Highways, social ABC (primary, secondary, urban) funds | ... | ... | ... | ... | ... | ... | 0.4 | 0.2 | 0.2 | 0.2 |
| Highways, in authorizations, Intered systems | ... | ... | ... | ... | ... | ... | 0.2 | 0.1 | 0.1 | 0.1 |
| Public works speed-up | ... | ... | ... | ... | ... | ... | 0.3 | 0.3 | 0.3 | 0.3 |
| Temporary extended unemployment compensation | ... | ... | ... | ... | ... | ... | 0.3 | 0.3 | 0.3 | 0.2 |
| Subtotal = implicit high employment surplus | 2.6 | 3.9 | 2.4 | -0.2 | 0.3 | -1.3 | -2.4 | 0.4 | 0.1 | -2.3 |
| Less: effect, built-in stabilizers | | | | | | | | | | |
| Corporate profits tax escrow | ... | 2.4 | 5.2 | 5.2 | 4.9 | 3.2 | 0.4 | 0.2 | -2.0 | -7.2 |
| Excise taxes | ... | 0.4 | 0.9 | 0.9 | 0.8 | 0.3 | 0.3 | -0.1 | -0.1 | -0.3 |
| Employment taxes | ... | 0.2 | 0.6 | 0.6 | 0.7 | 0.6 | 0.4 | 0.4 | 0.1 | -0.5 |
| Individual income tax escrow | ... | 1.3 | 2.7 | 2.7 | 2.3 | 2.7 | 2.3 | 1.1 | 0.3 | -2.4 |
| Unemployment compensation | ... | 0.7 | 1.3 | 1.3 | 2.2 | 2.1 | 1.4 | 0.4 | — | -1.3 |
| Other adjustments | ... | 0.2 | 0.2 | 0.2 | 0.5 | — | -0.3 | -1.0 | -1.1 | -1.3 |
| Total = actual surplus (net final income account basis) | 2.6 | -0.9 | -0.1 | -10.7 | -11.1 | -10.7 | -9.1 | -2.7 | 0.5 | 8.4 |

TABLE IX
19

FACTORS AFFECTING FEDERAL SURPLUS, 1957-59 RECESSION AND RECOVERY
(in billions of current dollars at seasonally adjusted rates)

• - Turning now to the FED's actions, we find that although the immediate impact of Federal Reserve policy was on commercial banks, it clearly had broader effects upon the economy generally. For one thing, since commercial banks are direct participants in some degree in all important credit markets, expansion in bank lending and investing activities intensified competition among all lenders for the acquisition of the available supply of creditworthy loans and securities. This worked to reduce the cost of financing to borrowers generally. It also widened access of all potential borrowers to credit funds. This easy money market no doubt was the prime factor that cushioned downward pressures on investment spending, and helped many companies to minimize cutbacks in their working force, to maintain dividends and to strengthen liquid positions.²⁰

Although the recovery in 1958 was not up to the high degree accomplished in 1955, it appears that this was due to the early reversal of the FED's easy money policies. The FED seems to be more interested in counteracting economic trends rather than sustaining real economic growth. Indeed, the FED appears to have its eye forever on the dangers of inflation.

The 1958 recession demonstrated greater political flexibility on the expenditure side than on the tax side of the budget. This is inherent in the fact that expenditure programs can be modified one at a time in a more gradual fashion, and defended on other than stabilization grounds. Such flexibility is a great advantage to the policy official, since recognition of recession -- first whether there is one, later how severe and chances of self-correction--proceeds slowly at best. The administration felt that a tax cut would have been a public

²⁰ Martin, op. cit., pp. 111-112.

admission of a serious recession, and they believed that when weighed against expenditure increases, there was really no other choice than to rule against a tax cut.²¹

Finally the 1958 recession was highlighted both by its sharpness of contraction and its rapid rebound. The recovery certainly would have been much slower without the prompt and aggressive actions of the administration, the congress and last but by no means least the Federal Reserve System. This recession, one of the shortest in our country's history, lasted but nine months.

²¹ Lewis, op. cit., p. 235.

CHAPTER VII

CONCLUSION

In the previous chapters the character and uses of fiscal and monetary policy and the related federal budget have been analyzed. Also, we have examined in detail two of the post World War II recessions. We have seen that when private investment and consumption spending are producing a deflationary gap it is the task of the federal government, through the application of fiscal and monetary policy, to offset the gap.

The principal monetary weapons are open-market operations, discount rate policy, and changing the legal reserve requirements of the member banks. The principal fiscal weapons to offset recessionary tendencies are tax-cuts and increases in government expenditure. Tax-rate changes have, in recent times, received more emphasis than in the past. This is in contrast with the great emphasis placed on emergency public works programs of earlier times, particularly during the Great Depression of the 1930's.

The modern economy is bolstered in periods of recession by built-in stabilizers requiring no discretionary action. Tax rates decrease automatically as incomes decrease resulting in lesser decreases in disposable income than in personal income. Unemployment compensation and other welfare transfers grow automatically during recessionary periods. The built-in stabilizers serve to oppose the recessionary tendency and to wipe out part of the deflationary gap.

Since the automatic stabilizers do not fully offset the instability of the economy the requirement arises for discretionary action. A government by laws, not by men, in which fiscal and monetary policies work automatically untouched by human hands, so to speak, is not now

anywhere in sight. However, modern innovations to reduce lags in diagnosis and corrective action are promising.¹ Such innovations include our vast system for collecting statistical data, advance legislation for tax-cuts, and pre-planned ready to go public works projects.

As the notion that the government's budget had to be balanced every year was modified, it was first thought that the budget would be in balance over the business cycle. That is with boom-time surpluses just matching the recession or depression deficits. Today it is realized that only by coincidence would the number of years of prosperity just balance in their intensity the number of years of depression. If the economy is in for "secular stagnation" with private savings and investment actions tending much of the time to produce deflationary gaps then fiscal policy will probably succeed in maintaining inflationless high employment only by having a secular increase in the public debt. If, on the other hand, the economy is due for "secular exhilaration" with demand so brisk as to lead much of the time to inflationary gaps, then fiscal policy will probably be in the form of surplus financing and there will be a secular downward trend in the public debt. These are, however, long-term concepts which would require some dubious predictions since the actual case will probably lie somewhere between the two extremes. At any rate we are generally prepared only to advocate action that the developing situation calls for.²

¹Paul A. Samuelson, Economics -- An Introductory Analysis (New York: McGraw-Hill Book Company, Inc., 1958), p. 361.

²Ibid.

In that regard, although we are not currently experiencing a recession, one of the most critical problems facing the United States is that of increasing the rate of economic growth. Fast as our economy is running today, all it is doing is standing still. Even though for the past ten years our economy has not failed to show an annual rise, and in spite of the fact that in 1963 we added more than \$30 billion to our total output of goods and services to reach a new peak of \$585 billion, the rate of growth has not been sufficient to decrease unemployment. At the end of 1963 our jobless rate was around 5-1/2 percent, and for the past six years it has been at 5 percent or more. The unemployment rate, in other words, is still considerably above the 4 percent rate which is normally considered tolerable. There are over four million Americans able and willing to work who cannot find jobs today. There were over four million Americans able and willing to work who could not find jobs a year ago. Wherever we turn we find the statistical evidence of this critical economic-social problem facing the United States--stubbornly high unemployment despite a sustained period of prosperity.³

Reduction in hours of work has been suggested as a possible solution to the unemployment problem. In 1961 Dr. Tore Tjersland stated:

In the decade ahead, it is expected that growth of total factor productivity and gross national product at rates comparable to those experienced in the past will continue. These factors, added to the anticipated rapid increase in number of persons seeking employment will combine to produce a situation

³

Sylvia Porter, "Your Money's Worth," Monterey Peninsula Herald, January 8, 1964.

which may again call for consideration of reducing hours of work in order to maintain high levels of employment opportunities.⁴

That there should be job opportunities in useful employment for individuals willing and able to work is one of the many important objectives of our society. The problem of policy is to achieve the high employment objective more successfully without sacrificing the achievement of other goals. Among the other objectives that are closely related to the achievement of a high rate of economic growth and the achievement of steady, high employment are:

1. Rapid growth of total output per person which is the source of rising living standards and the means for achieving other national goals.
2. Production of those goods and services that the American people want most.
3. Preservation of economic freedom, which requires limitation of the scale and character of government economic activities and controls.
4. Avoidance of inflation.
5. Maintenance of the international value of the dollar.

⁴ Tore Tjersland, "Some Aspects of Employment Problems Facing the United States in the Period 1960 Through 1970" (Unpublished Doctoral dissertation, Stanford University, Palo Alto, 1961), p. 90.

Policies selected to promote economic growth and high employment should not sacrifice these other important objectives, but on the contrary should help achieve them. In a free enterprise society these objectives can be attained only if a high and growing level of business activity exists. The goal then is the creation by government, labor and business of a climate and set of conditions which make such a level possible. In a free enterprise society an understanding and acceptance of the fact that adequate current and anticipated profits are fully as important as wages, salaries and taxes is an essential element of both climate and conditions.⁵ Of critical importance to this issue is labor's understanding the necessity for profits and business growth and governmental willingness to promote a suitable business climate through the execution of federal fiscal and monetary policies.

The tax cuts approved for 1964 and 1965 are an example of positive federal fiscal policy to promote economic growth. It can be shown by assuming a Marginal Propensity to Consume of .78 (see Table X), that the \$11.5 billion tax cut should produce about a \$40.8 billion increase in GNP. This amount is arrived at as follows:

$$\begin{aligned}\Delta Y &= kb \times \Delta T \\ &= \frac{1}{1-.78} \times .78 \times 11.5 \\ &= \frac{.78}{.22} \times 11.5 \\ &= 3.55 \times 11.5 \\ &= 40.8\end{aligned}$$

⁵ Committee For Economic Development, Fiscal and Monetary Policy for High Employment (New York: January 1962), pp. 7-8.

Where: ΔY = increase in GNP

k_b = "Tax Multiplier"

$$k = \frac{1}{1-b}$$

b = Marginal Propensity to Consume

ΔT = amount of tax reduction

By way of contrast it can be shown, again assuming a marginal propensity to consume of .78, that if instead of an \$11.5 billion tax cut we were to increase government spending by \$11.5 billion, there would be induced a \$52.3 billion increase in GNP. The computation is as follows:

$$\Delta Y = k \times \Delta (C + G + I)$$

$$= \frac{1}{1-.78} \times 11.5$$

$$= \frac{1}{.22} \times 11.5$$

$$= 4.55 \times 11.5$$

$$= \underline{\underline{52.3}}$$

Where: ΔY = increase in GNP

$k = \frac{1}{1-b}$ = "Government Spending Multiplier"

$\Delta(C+G+I)$ = Increase in components of GNP; in this case same as ΔG or \$11.5 billion.

TABLE X
CALCULATION OF AGGREGATE MARGINAL PROPENSITY TO CONSUME⁶

| Disposable Income | Consumption Expenditure | MPC | Proportion of Consumer Units | Computation of Aggregate |
|-------------------|-------------------------|---------------------------|------------------------------|--------------------------|
| \$1000 | \$1278 | $\frac{490}{1000} = .49$ | .134 | .06566 |
| 2000 | 1768 | $\frac{950}{1000} = .95$ | .206 | .19570 |
| 3000 | 2718 | $\frac{852}{1000} = .85$ | .261 | .22185 |
| 4000 | 3570 | $\frac{880}{1000} = .88$ | .185 | .16280 |
| 5000 | 4450 | $\frac{807}{1000} = .81$ | .106 | .08586 |
| 6000 | 5257 | $\frac{786}{1000} = .52$ | .070 | .03640 |
| 7500 | 6043 | $\frac{1500}{1065} = .43$ | .038 | .01634 |
| 10000 | 7108 | $\frac{2500}{1000} = .25$ | | |
| | | | 1.000 | .78461 |

⁶The raw data used in these computations was obtained from the National Industrial Conference Board, The Economic Almanac, 1964, published in cooperation with Newsweek, (New York, 1964), p. 387. The data is based on a study performed by the Wharton School of Finance and Commerce in cooperation with the Bureau of Labor Statistics under a grant from the Ford Foundation. Not included in the computation are the consumer units with over \$10,000 disposable income. They represent only approximately 2.5% of the total consumer units and it can reasonably be assumed that their effect on the Aggregate Marginal Propensity to consume would be to decrease it slightly -- probably no more than the difference between .78461 and the rounded off figure of .78

As can be seen from these computations an increase in government spending would produce a greater increase in GNP than does an equal tax cut. In other words, dollar for dollar, changes in taxes have a weaker income-generating effect than changes in expenditures. For the derivation of formulas and other information concerning the Government Spending and Tax Multipliers, see Appendix I.⁷

The question then arises, if increased government expenditures can produce a greater increase in GNP than does a tax cut, then why do we choose to cut taxes instead of increasing government expenditures? A simple answer to this question is that tax cuts are in general popular and that government spending is unpopular. The first question that the average man asks when he thinks of taxes or government expenditures is: "What does this mean to me?" The increase in his disposable income as a result of a tax cut is real and tangible, whereas the possible benefits of increased government expenditure for, say a new dam in another part of the country or economic aid to Somalia, are likely to be vague and intangible. In this sense then the tax cut vice an increase in government spending is a political response to the desires of the people.

This is not to say, however, that people always favor tax cuts. In time of war, for example, the American people realize that they must give up some private consumption for the war effort. Furthermore, if resources were released, from, say, the defense program or foreign

⁷ For amplifying information see W. A. Salant, "Taxes, Income Determination, and the Balanced Budget Theorem," Review of Economics and Statistics (May, 1957), pp. 152-161.

aid, the people might want to spend part of such resources on public projects such as roads, education, public health, etc.

The question of whether to cut taxes or increase government expenditures is a matter of social priority. And in our society, if public consumption projects have a lower social priority than private consumption then the proper fiscal policy is one of tax reduction. Of course the reverse of this is true also.

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APPENDIX I
GOVERNMENT SPENDING AND TAX MULTIPLIERS¹

Variables

Identify the following variables: Y_t , income (or net national products); C_t , consumption expenditures by households; G_t government expenditures; and I_t , net private investment. The subscript t indicates time-- Y_t is thus income in time t measured in days, months, years, etc., from some arbitrary (coded) starting point $t = 0$.

Model A

Define Y_t as the sum of household, government, and business demand for current output. Let C_t be proportional to Y_t where the factor of proportionality is designated b . The constant b , known as the Marginal Propensity to Consume, is defined as the ratio of the change in C_t associated with a change in Y_t . These two assumptions, one definitional and the other behavioral, can be put into symbolic form as follows:

$$(1) \quad Y_t = C_t + G_t + I_t$$

$$(2) \quad C_t = bY_t \quad \text{or} \quad \Delta C_t / \Delta Y_t = b$$

Solving this 2-equation model by substituting (2) into (1) and then simplifying yields the equilibrium result.

$$(3) \quad Y_t = \frac{1}{1-b} [G_t + I_t]$$

¹ Reproduced with permission from an unpublished economics course outline prepared by Dr. Tore Tjersland at the U. S. Naval Postgraduate School, Monterey, California, (Fall 1962), pp. 23-26.

The term $1/(1-b)$ has a special name, the simple Keynesian multiplier, and a special symbol, k . Clearly, if households either consume or save each dollar of income, then there must be something called the Marginal Propensity to Spend which is analogous to MPC and such that $MPC + MPS = 1$. Thus, the multiplier can also be defined as the reciprocal of the MPS.

Example

Suppose $G_t + I_t = 120$ say, billions of dollars and $b = 0.6$.

It follows that $k = 2.5$ and

$$Y_t = k(G_t + I_t) = 2.5(120) = 300$$

Suppose that G_t increased by 10. The new level of income can be computed in two ways:

$$(i) \Delta Y_t = k \Delta(C_t + G_t + I_t) = 2.5(10) = 25$$

$$Y_t = "the\ old\ Y_t" + Y_t' = 300 + 25 = 325$$

$$(ii) \quad Y_t = k(G_t + I_t) = 2.5(120 + 10) = 325.$$

Modification of Model A.

Let C_t be a linear function of Y_t . The solution to the model now becomes, where A_t is defined (for convenience) as the sum of the exogenous (or autonomous) spending, as shown in (3'):

(1) as before

$$(2') \quad C_t = a + b Y_t$$

$$(3') \quad Y_t = \frac{1}{1-b} [a + G_t + I_t] = kA_t$$

Example:

Suppose $G_t + I_t = 120$ and $b = 0.6$ as before, and that $a = 10$.

Then $k = 2.5$ but

$$Y_t = kA_t = 2.5(130) = 325.$$

Clearly, autonomous increases in consumer spending ($=a$) have the same effect on income as similar increases in business or government spending. That is, the multiplier effect of an increased exogenous spending is the same, k , regardless of the source -- households, firms or governments. Whether or not this is actually true is a hotly debated question, at least among politicians. This is obviously one of the places where Model A could be tested to find out whether it is a good model or not.

Another Modification of Model A.

In addition to including government spending explicitly it might be desirable to have a model which contained a variable for government taxes. It would then be possible to derive a "tax multiplier" to compare with the "government spending multiplier" in order to decide if changes in taxes or government spending had the larger effect on income. All that is required is that the consumption hypothesis be modified to read as follows: household spending is linearly related to disposable income where disposable income is defined as net national product less government taxes (T_t). Then:

(1) as before

$$(2'') C_t = a + b(Y_t - T_t)$$

$$(3'') \quad Y_t = \frac{1}{1-b} A_t - \frac{1}{1-b} b T_t \\ = k A_t - kb T_t.$$

Suppose $b = 0.6$ as before so that $k_g = k_i = k_a = k_A = 2.5$. In other words, a dollar increase in government spending (to pick one) generates a \$2.50 change in income. Define the tax multiplier as $k_T = -\frac{Y_t}{T_t}$.

Then -

$$k_T = -(-kb) = (2.5)(0.6) = 1.5$$

In other words, a dollar change in taxes leads to a change of \$1.50 in net national income. This result, known as the balanced budget theorem, denies that a balanced budget is fiscally neutral; a rising but balanced budget clearly exerts a net expansionary effect on income in this Model, just as a falling but balanced budget has a contractionary impact.

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